Une recherche exploratoire sur les stratégies d'investissement des fonds d'investissement en micro-finance

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To:

my parents

my parents in law

my beloved husband, Pheakdei MAUK

my lovely daughter, Victoria Vicheaneath MAUK

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Abstract

This thesis specifically investigates the investment strategy of microfinance investment funds from contextual data, employing a qualitative content analysis approach, contrasting with previous studies that have often developed models for performance evaluation and examined whether investment in microfinance provides additional value for investors through quantitative techniques. Written information from 84 microfinance fund websites has been used as secondary sources, in order to search for the particular components contributing to the formulation of a well-designed investment strategy, and to answer to the main research question of this thesis. We scrutinize how fund managers perform the selection of investments in eligible microfinance institutions, and explore their guidelines and objectives of investment. This study examines only the information that microfinance investment funds are willing to inform to relevant parties regarding to their perspective and investment conditions in microfinance, and the scope does not extend to investors and microfinance institutions aspects.

Content analysis has produced the categorical data which can be counted and cross-tabulated for descriptive statistics to compare with earlier studies. This study finds that social and financial return, along with environmental concerns, are the motivation for investment in microfinance. Funds provide financing through equity, loan/debt instrument and loan guarantee basis. We also observed that debt investments, foreign currency investment, and institutional investors are dominant in this study, and these findings are consistent with previous quantitative studies. The tenor, size, currency, collateral, return, date of repayment, and risk are found as characteristics of the financing instruments which are a crucial part of the strategy to invest in microfinance,

but they were not significantly highlighted on find websites; this suggests that all funds should include these elements in their information for investors or others relevant parties. We also tested the relationship between bi-categories by using chi-square to see whether financing instruments are linked to the type of institutions and investor types. There is little evidence to suggest that these are associated.

Finally, the study examines the information on investment strategy that is available on the website of microfinance funds in an effort to contribute to literature on microfinance. It includes investment objectives, selection criteria for eligible investments, investment sectors, investment instruments and their terms, funding structure, geographical distribution, risk, return, hedging, leverage, exit strategies, and investment selection procedures. The study's findings suggest future research employing broader data sources, in particular to examine both investors and the microfinance institution sides, in order to obtain an effective investment strategy that is well matched with all relevant parties' preferences. Subsequently, an evaluation of the impact of this strategy on investment decision should also be studied.

Résumé de la thèse en français

La microfinance est réputée dans le monde entier comme un instrument potentiel pouvant contribuer à la réduction de la pauvreté et à l'accroissement de la croissance économique dans les pays en développement. La microfinance implique non seulement l'accès aux capitaux et leur distribution, mais aussi plus spécifiquement à la façon dont ces capitaux sont utilisés, investis et épargnés. Elle permet généralement le renforcement des capacités de ceux qui ont recours à ses services, ce qui contribue à améliorer la confiance en soi, et leur offre ainsi de nouvelles occasions de participer à des activités économiques, sociales et politiques. La microfinance intègre les besoins financiers des populations pauvres et à faible revenu dans le système financier traditionnel d'un pays, dans le but de les aider à augmenter leurs revenus, à accumuler des actifs et/ou à se protéger contre des chocs externes. Par conséquent, elle joue un rôle vital à la fois financièrement et socialement. Les institutions de microfinance (IMF) se définissent comme des institutions qui offrent des services de microfinance. Ces institutions ont développées une large gamme de services, y compris le micro-crédit, la micro-épargne, la micro-assurance et les services de mise à disposition de fonds, en utilisant des méthodes innovantes et des technologies modernes. Le succès et la croissance constante de la microfinance a bénéficié pleinement des nouvelles pratiques de prêt dans le cadre du modèle des micro-prêts entre particuliers (aussi appelé micro-prêts solidaires) de la Grameen Bank, au Bangladesh. Généralement, les clients de la microfinance sont des entrepreneurs indépendants exerçant leur activité à domicile, et environ les deux tiers sont des femmes, tant dans les zones rurales qu'urbaines (Novak, 2011). Les clients dans les zones rurales sont généralement des petits agriculteurs et des personnes qui se livrent à de petites activités génératrices de

revenus telles que la transformation d'aliments et le petit commerce, alors que dans les zones urbaines les activités sont plus variées: commerce, prestations de services, artisanat, vente ambulante, etc. Les services de microfinance ne sont pas destinés à financer seulement des opportunités d'investissement, elles peuvent aussi être utilisées pour faire face à des urgences personnelles (maladie, accident, vol, décès) ou des catastrophes (inondation, incendie, cyclone).

Le nombre d'institutions de microfinance est estimé actuellement à plus de 10 000 réparties dans 85 pays dans le monde. Ces institutions de distribution et de commercialisation des services de microfinance revêtent différentes formes telles que des organisations non gouvernementales (ONG), des coopératives, des coopératives de crédit, des promoteurs immobiliers, des banques commerciales et des banques rurales. On s'attend à un fort accroissement des services de microfinance pour répondre à la demande de millions de ménages économiquement pauvres à travers le monde. La forte augmentation de la demande venant des micro et petites entreprises et des ménages pauvres ou à faible revenus pour des services financiers liés à des activités génératrices de revenus constitue un potentiel d'augmentation des activités des IMF. On estime que le secteur de la microfinance reste confronté à un déficit de financement important de l'ordre de 231 milliards de dollars US pour satisfaire pleinement la demande de long terme, et à près de 275 milliards de dollars US en termes de financement total composé de dette, dette subordonnée, capitaux propres, dépôts et garanties (Dieckmann, 2007). Les organismes gouvernementaux de développement et les donateurs sont prédominants dans la fourniture de bourses, de subventions et de support technique aux IMF. Cependant, les sources de financement existantes ne sont pas suffisantes et sont de moins en moins en mesure de répondre à cette demande inexploitée, aussi d'autres sources de financement sont recherchées pour les opérations de long terme. La plupart des IMF, conçues sous forme d'ONG souvent peu efficaces financées par des financements traditionnels, désire se transformer en institutions financières réglementées financés par des capitaux privés, afin d'élargir leurs sources de financement et accroître leur viabilité financière. La microfinance a déjà suscité l'intérêt d'investisseurs potentiels par le recours aux marchés de capitaux, générant une sensibilisation aux services de microfinance et favorisant de plus en plus la survie économique des IMF. Certaines IMF bien gérées et plus intégrées dans la finance traditionnelle cherchent à commercialiser plus d'investissements en microfinance en misant sur le financement public pour attirer des fonds privés. Ainsi, certaines institutions ont élargi leurs sources de financement, en mobilisant l'épargne, en émettant des emprunts, et même en émettant des titres et des obligations sur les marchés des capitaux.

Constatant l'augmentation des besoins des IMF en ressources financières pour faire face à leur croissance constante, les investisseurs individuels et institutionnels orientés vers le développement social sont devenus plus intéressés et impliqués dans le financement de ce secteur. Ils peuvent ainsi investir soit directement dans une IMF soit aux travers d'intermédiaires financiers appelés fonds d'investissement en microfinance. Selon le CGAP (2010b), un fonds d'investissement en microfinance est une société d'investissement qui inclut la microfinance comme l'un de ses objectifs ou mandats de placement fondamentaux. Avec l'augmentation des besoins en ressources financières, ces fonds d'investissement peuvent être créés afin de faire des profits soit par certaines IMF qui continuent à offrir des services aux pauvres pour les opérations durables (Goodman, 2006) soit par des institutions indépendantes ou des gestionnaires de fonds investissant dans des institutions de microfinance.

Les fonds de microfinance sont considérés comme un marché émergent, et ont joué un rôle important dans la collecte de capitaux de différents types d'investisseurs pour refinancer des IMF diversifiées, une particularité qui les distingue de fonds sur les marchés développés. Ces nouveaux fonds d'investissement sont de nouvelles opportunités tant pour les prestataires de services de microfinance que pour les investisseurs. Depuis les années 1990, ces fonds ont gagné en popularité et accompagné progressivement le développement de l'industrie de la microfinance. Ceci peut être attesté par l'augmentation des actifs de ces fonds qui sont passés de 1 milliard de dollars en 2005 à près de 7 milliards de dollars en 2011, avec environ 102 fonds individuels dans le monde. Cette augmentation des investissements en microfinance, permet aux IMF d'une part d'atteindre le financement nécessaire à une diffusion à plus grande échelle d'une gamme élargie de produits et services financiers, et d'autre part d'augmenter la profondeur de leur portefeuille pour inclure un plus grand nombre de clients pauvres et non pauvres qui étaient auparavant exclus du système financier formel.

Les fonds de microfinance offrent aux investisseurs nationaux et internationaux des possibilités d'investir indirectes dans un large éventail de portefeuilles d'IMF. Une variété d'investisseurs privés, de l'investisseur individuel au particulier fortuné, et d'investisseurs institutionnels, est de plus en plus à la recherche de moyens efficaces pour investir des capitaux dans la microfinance. Ces investisseurs sont souvent considérés comme des investisseurs socialement responsables sensibles à un double objectif de rentabilité financière et sociale. Le capital de certains fonds de microfinance est très peu liquide, le prix du marché est essentiellement ce que l'investisseur est prêt à payer. Les investisseurs peuvent non seulement faire un investissement direct dans un fonds d'investissement en microfinance qui à son tour investit dans une IMF, mais aussi un investissement indirect via un fonds de fonds qui à son tour investit dans un fonds. Parallèlement, les fonds d'investissement en microfinance peuvent investir directement ou indirectement dans un portefeuille de microfinance. Ces fonds bénéficient de différentes sources de financement, en raison d'une approche d'investissement diversifiée qui associe rentabilités sociale et financière. Les fonds les plus socialement orientés sont généralement financés par des agences de développement et des donateurs privés, tandis que les investisseurs financiers et les investisseurs socialement responsables financent les fonds les plus financièrement orientés (Galema et Lensink, 2009). Étant donné que la caractéristique spécifique des fonds de microfinance est l'importance de l'impact social positif du capital investi, il n'est pas facile pour les gestionnaires de fonds d'équilibrer raisonnablement rentabilités financière et sociale, et de minimiser de manière cohérente les risques. Les fonds d'investissement en microfinance peuvent être différenciés par des stratégies d'investissement spécifiques qui offrent un associe un risque financier et des performances financière et sociale. Les investisseurs peuvent, à leur tour, prendre des décisions d'investissement en organisant leurs propres priorités, scrutant les stratégies et les performances, et en sélectionnant des fonds qui correspondent le mieux à leurs préférences. Toutefois, le nombre croissant et la variété des fonds de microfinance peuvent compliquer le processus décisionnel.

Alors que l'industrie arrive à maturité, les investisseurs actuels et potentiels ont des difficultés pour comparer et étudier ces fonds en raison de l'absence d'une information accessible, standardisée et transparente et d'analyses objectives de tiers. L'intérêt croissant de la part d'investisseurs, de chercheurs universitaires et de praticiens de l'investissement en microfinance ont favorisé le développement d'études sur ce segment. La plupart des études ont utilisé des données quantitatives pour évaluer la performance des fonds pour apprécier si l'investissement en microfinance génère de la valeur pour l'investisseur, ou pour observer des changements importants dans le nombre de fonds, la valeur des actifs ou des tendances dans l'utilisation des instruments, des devises, la répartition régionale, etc. Toutefois, ces études antérieures n'ont pas fourni aux investisseurs et parties concernées des informations détaillées sur les critères d'investissement, les procédures et le comportement d'investissement des fonds de microfinance. En outre, il existe très peu d'études basées sur l'information textuelle mise à disposition par les fonds de microfinance, en particulier sur leurs sites en ligne, pour étudier les stratégies d'investissement les plus souvent expliquées au public, aux investisseurs et investisseurs potentiels, afin de promouvoir le segment de la microfinance, ou de vendre des fonds individuels. Aussi, cette thèse tente de combler cette lacune en étudiant spécifiquement la stratégie d'investissement des fonds d'investissement en microfinance à partir de données textuelles, en utilisant une approche d'analyse de contenu qualitative, ce qui contraste avec les études antérieures fondées sur des techniques quantitatives. Elle vise à comprendre quels genres de données sur les comportements d'investissement les fonds de microfinance veulent communiquer aux investisseurs et aux institutions de microfinance. D'où la question de recherche principale: Comment les stratégies d'investissement des fonds d'investissement en microfinance sont-elles conçues? Pour répondre à cette question de recherche, une série de sous-questions sont proposées sur la base de la littérature existante et des recherches précédentes, en utilisant une méthodologie qui met l'accent sur les données textuelles.

1. À quelles fins les fonds de microfinance investissent-ils en microfinance?
2. Quels sont les critères de sélection des investissements?
3. Qui sont les partenaires éligibles?
4. Quels sont les produits et les termes clés présentés aux institutions de microfinance?
5. Comment les fonds de microfinance sélectionnent-ils les financements d'une institution éligible?
6. Quelles sont les sources de financement des fonds de microfinance?

7. Quelle est la répartition géographique des fonds de microfinance?

8. Quels sont les risques et les rentabilités des investissements en microfinance?

9. Est-ce que les stratégies de couverture et de sortie sont présentées? Si oui, quels sont-elles?

10. Est-ce que les principaux produits fournis aux partenaires éligibles sont liés à leur forme juridique particulière ou à leur stade de développement?

Cette thèse examine comment les gestionnaires de fonds effectuent la sélection des investissements dans les institutions de microfinance éligibles, et explore leurs orientations et objectifs d'investissement. Elle cherche à fournir une analyse approfondie, transparente et détaillée des stratégies d'investissement documentée comme un modèle global contribuant à la littérature sur la microfinance qui sera utilisé comme une information fouillée et efficace pour amener à une claire perception de l'investissement en microfinance. De même, elle fournit des informations essentielles non seulement aux investisseurs pour sélectionner et prendre des décisions d'investissement précises mais aussi aux IMF pour comprendre et mieux se préparer à un accès à des ressources de financement supplémentaires provenant de fonds d'investissement en microfinance. L'étude s'est limitée à une technique d'analyse qualitative du contenu de nature exploratoire pour mettre en évidence les constituants particuliers des stratégies d'investissement. Les résultats peuvent être généralisés seulement à l'information en ligne, et ne peuvent pas être élargies aux stratégies d'investissement de la microfinance dans son ensemble.

La technique sous-jacente de l'analyse de contenu se rapporte à l'analyse et à la synthèse d'une grande quantité d'informations textuelles, dans laquelle de nombreux mots et textes sont classés en catégories de contenu, puis chaque occurrence de mot ou de phrase est codée et comptée. Il ne s'agit pas seulement de compter la fréquence; l'analyse de contenu peut être utilisée pour décrire la conception ou la perception d'un matériau écrit (prospectus, message en ligne, rapport annuel, brochure, etc.) pour mettre en évidence des points de vue dominants et leurs raisons d'être. En retenant ces principes d'analyse de contenu, la littérature sur des sujets connexes, l'objectif de cette thèse, et le nombre peu important d'études antérieures, l'analyse de contenu apparait par conséquent comme appropriée pour cette recherche. Les informations écrites qui concernent la stratégie d'investissement en microfinance de 84 sites en ligne de fonds de microfinance ont été utilisées comme sources secondaires, afin de rechercher les éléments particuliers qui contribuent à la formulation d'une stratégie d'investissement bien conçue, et pour répondre à la question de recherche principale de cette thèse. La sélection de l'échantillon résulte du groupe d'entités classées comme fonds d'investissement en microfinance sur le site Microfinance Information Exchange (MIX).

L'analyse de données a commencé avec la lecture détaillée et répétée de toutes les informations recueillies, visant à s'immerger dans les données et à obtenir une solide compréhension du contenu et de la signification de l'ensemble. Lors de la lecture initiale des données, une table a été créée manuellement pour prendre des notes sur les mots ou contenus clés qui se dégageaient souvent des messages comme objectif, titre, prêt, actionnaire, critères d'éligibilité, etc. Cela a conduit à la création d'une archive manuelle pour aider à la détermination des idées, des problèmes, et en particulier des mots-clés essentiels. En fonction des occurrences textuelles, de la question de recherche exploratoire de l'étude et de son orientation sur les perceptions, nous avons décidé d'utiliser des thèmes comme unité d'analyse. Ces thèmes pouvaient s'exprimer par un mot, une expression, un paragraphe, une phrase ou un document entier. Les catégories ont été initialement tirées de la lecture et de la mise en évidence de mots ou contenu de données textuelles qui paraissaient capturer la première impression, la pensée ou les concepts clés. Plusieurs sous-catégories ont été créées et regroupées dans un plus petit nombre de catégories. La définition de chaque catégorie et sous-catégorie a été donnée, en fonction des informations issues des données et d'études ou publications antérieures, pour constituer un ensemble cohérent de catégories susceptibles d'expliquer les thèmes. Le schéma de codage a été initialement créé avec un nombre important de catégories qui a été réduit à une liste de seulement 12 catégories. Après avoir énuméré les catégories précédemment définies, toutes les données brutes ont été importées pour codage en utilisant le logiciel d'analyse de données qualitatives NVivo 8.

Au début du processus de codage, une partie de texte a été codé en sous-catégorie. Il n'y a pas eu de codes abrégés en mot ou symbole appliqués au texte pour ce codage de données puisque l'unité de texte ou les mots clés ont été mis en évidence et directement classés dans chaque catégorie. Une unité de texte pouvait être assignée à plus d'une catégorie simultanément. En cours de codage, en présence de nouvelles questions ou de contenus qui ne pouvaient être attribuées à des catégories existantes de manière adéquate, de nouvelles catégories ont été créées qui ont pu être utilisées pour des données ultérieures. Par conséquent, la plupart des catégories et des thèmes de cette étude ont été identifiés à partir des données sur la base d'un codage minutieux, d'une classification et d'une comparaison constante. Nous avons cherché des définitions semblables provenant d'études ou de théories antérieures similaires comme guide pour les définitions et comme liste de contrôle pour le contenu émergent. La classification des catégories dans le processus de codage s'est principalement appuyée sur le contenu manifeste tandis que le contenu latent des textes a été partiellement utilisé. La question la plus épineuse dans l'analyse de contenu concerne la décision d'attribution d'un texte à une catégorie (McKee, 2003). À la fin du codage, toutes les catégories ont été revérifiées une par une par rapport à l'ensemble des données originales. Ceci a conduit à fusionner certaines sous-catégories dans la catégorie principale quand il y avait un degré élevé de similitude et de complémentarité. Dans cette étude, le nombre de fois où une catégorie a été décrite dans les sources de données a été négligé au profit de la présence ou de l'absence d'une catégorie particulière dans chaque texte recueilli. Aussi, pour les sous-catégories identifiées, les fréquences correspondent au nombre de fonds présents pour lesquels il y a ou pas la sous-catégorie. Les résultats de recherche adéquats étant présentés en décrivant le large éventail de catégories et thèmes définis, et en divulguant les modèles de thèmes importants et les idées des fonds de microfinance, il est alors important de lier la réponse aux questions de recherche. La description et l'interprétation de chaque catégorie en fonction de la question de recherche a été complétée par une explication des sous-catégories, qui ont été codées à partir des données brutes. Les résultats ont été restitués et discutés simultanément. Nous avons discuté nos résultats en les comparant avec la littérature existante sur des sujets connexes; les résultats sont comptabilisés et présentés sous forme d'une simple totalisation des variables et sous forme d'analyses croisées en vue de comparaison avec des études similaires précédentes. Lors de l'interprétation des résultats, des citations d'unités de texte ont été extraites des données textuelles pour justifier les conclusions et soutenir l'expression des idées. Enfin, les données catégorisées ont été affichées dans un tableau de contingence qui a été utilisé pour identifier la relation entre catégories, ou entre sous-catégories et catégories.

De l'analyse des données contextuelles, il est ressorti que l'objectif des fonds pour investir en microfinance est parallèle à celui des institutions de microfinance: une tentative de création de rentabilité financière significative et d'impact positif sur la société. Certains fonds visent également à un triple objectif qui met l'accent non seulement sur des valeurs sociale et financière, mais aussi sur la valeur de l'environnement, afin d'éviter de nuire au succès du segment de la microfinance. Des critères de sélection des investissements, connus pour être des indicateurs importants dans la prise de décision d'investissement, ont été confirmés en tant que composants de la stratégie d'investissement des fonds de microfinance. Il s'agit d'un certain nombre de critères internes que les institutions candidates doivent satisfaire si elles veulent obtenir des financements, tels que la durée de l'opération, le montant minimum de l'actif ou du capital, la situation du pays, les formes juridiques, les critères de mission sociale, le portefeuille de prêts, la qualité financière, la qualité de la gestion et du fonctionnement. Certains fonds ont des critères de sélection différents mettant principalement l'accent sur la qualité des institutions et la mission sociale. La condition essentielle d'une mission sociale est une caractéristique unique de l'investissement dans la microfinance, ce qui reflète que l'impact social influence leur décision d'investissement. Des fonds ciblent des institutions formelles et semi-formelles qui fournissent des services de microfinance aux bénéficiaires finaux. Les fonds financent en priorité la phase d'expansion (institutions tournées vers la taille moyenne et la croissance), suivie par la phase d'amorçage et la phase de maturité. Les fonds de microfinance offrent un financement direct, non seulement aux IMF, mais ils ont aussi commencé à se tourner vers de secteurs tels que les PME, le commerce équitable et les producteurs associés. Les résultats de cette étude sont en accord avec les études quantitatives précédentes sur le fait que les investissements en dette, les investissements en devises étrangères et les investisseurs institutionnels prédominent. Les fonds fournissent un financement par capitaux propres, par prêts/emprunts et garantie de prêt. D'autres outils tels que les prêts de quasi-fonds propres ou convertibles, les dépôts à terme, les subventions et le financement de l'assistance technique sont également utilisés. Le financement par prêt est principalement offert pour les phases d'expansion et de maturité, pour soutenir la croissance du portefeuille et pour prêter de nouveau. Le placement en actions est réalisé principalement au stade d'amorçage de l'IMF, avec l'intention d'obtenir une participation minoritaire dans le capital, tandis que les garanties de prêt visent à permettre aux IMF d'obtenir un financement nécessaire auprès des banques commerciales locales. L'opérateur, la taille, la devise, les garanties, la rentabilité, la date de remboursement et les risques sont des caractéristiques des instruments financiers qui représentent une part cruciale de la stratégie d'investissement en microfinance, ce qui suggère que tous les fonds doivent inclure ces éléments dans leur information pour les investisseurs ou les autres tiers, mais ils ne sont pas significativement mis en évidence sur les sites en ligne.

L'implication croissante des investisseurs institutionnels a une influence sur la prise de décision d'investissement, ce qui peut conduire des fonds de microfinance à mettre en avant à destination de ces investisseurs la performance financière. La majorité des fonds de microfinance sont investis en Asie et en Afrique. Les fonds de microfinance présentent en général le profil de risque des institutions de microfinance sachant que le risque de leurs investissements est cohérent avec celui des IMF tels que les risques de change et de crédit. Les fonds utilisent des mécanismes pour se protéger et réduire leurs risques, avec des swaps de devises, par l'intervention de tiers, par une diversification internationale suffisante (pour le risque de change), et en examinant de façon rigoureuse les organismes candidats en s'intéressant aux critères de placement retenus d'après le processus d'investissement (voir Figure: 5.2). Fondamentalement, les fonds estiment que la diversification des investissements dans les IMF plus importants et plus diversifiés permet de réduire les risques et de renforcer les actifs du portefeuille. La qualité élevée des micro-prêts vient d'un taux de remboursement élevé et d'un faible taux de défaillance; le taux élevé de remboursement constituant une incitation pour les fonds de microfinance. Certains fonds proposent des rentabilités à un taux égal ou légèrement supérieur au taux du marché monétaire, tandis que d'autres fonds, plus orientés vers la performance sociale, offrent un taux au-dessous du taux du marché ou inférieur à celui d'autres actifs sur les marchés des capitaux. Nous avons trouvé très peu de fonds moins de 15% du total qui évoquent les stratégies de sortie, de levier financier et de couverture. Enfin, nous constatons que le processus de sélection des investissements représente une part essentielle de la stratégie d'investissement. Six étapes séquentielles sont mis en évidence: analyse du marché et des investissements, due diligence et révision, approbation de l'investissement, décaissement du prêt, reporting et phase de suivi (voir la Figure: 5.2). Chaque étape nécessite du temps et des ressources afin de prendre une bonne décision dans le choix d'investir dans des partenaires qualifiés. Les résultats dans NVivo.8 produisent des données catégorielles, nous permettant de tester la relation entre bi-catégories à l'aide du chi-carré pour voir si les instruments de financement sont liés à la nature des institutions et aux types d'investisseurs. Cette relation apparait peu significative.

Ainsi, la composante de la stratégie d'investissement du fonds de microfinance dans cette étude comprend l'objectif d'investissement, des critères d'éligibilité de l'investissement, le secteur d'investissement ou les partenaires éligibles, les instruments de financement et leurs modalités, la structure de financement, la répartition géographique, le risque, la rentabilité, l'endettement, la couverture, la stratégie de sortie et le processus de sélection de l'investissement. Cette recherche montre un résultat peu documenté dans la littérature existante en recourant à une nouvelle technique d'analyse du segment de la microfinance. En conséquence, cette recherche est intéressante pour les gestionnaires de fonds de microfinance, pour les investisseurs et pour les institutions de microfinance pour leur permettre de mieux comprendre d'une part à quoi la stratégie d'investissement du fonds correspond, et d'autre part le comportement et les conditions d'investissement des fonds de microfinance. Les réponses à chaque sous-question sont cohérentes avec la littérature existante ou des études antérieures à l'exception de la structure globale de la stratégie d'investissement. Les informations relatives aux fonds d'investissement en microfinance sont rarement accessibles au public, et les études antérieures ont porté sur l'évaluation de la performance en utilisant principalement des analyses quantitatives. Les études contextuelles ont été moins mises en œuvre et n'ont jamais été utilisées pour étudier la stratégie d'investissement des fonds de microfinance. Les conclusions de l'étude suggèrent des recherches futures utilisant des sources de données plus larges, en particulier pour étudier les investisseurs et les institutions de microfinance pour obtenir une stratégie d'investissement efficace adaptée aux préférences de toutes les parties concernées. Par la suite, une évaluation de l'impact de cette stratégie sur la décision d'investissement pourrait être envisagée.

List of Abbreviations

AFD	Agence Française de Développement
ASCA	Accumulating Saving and Credit Association
BIO	Belgian Investment Company for Developing Countries
CAF	Corporación Andina de Fomento
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
EAP	East Asia and Pacific
ECA	Eastern Europe and Central Asia
EIB	European Investment Bank
FMO	Dutch Development Agency
FSA	Financial Service Association
GTZ	Gesellschaft für Internationale Zusammenarbeit
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	India Financial Inclusion Fund
IIC	Inter-American Investment Corporation
KtW	Kreditanstalt für Wiederaufbau
LCA	Latin America and Caribbean
MENA	Middle East North Africa
MFI	Microfinance Institution
MFIF	Microfinance Investment Fund
MIV	Microfinance Investment Vehicle
NBFI	Non Bank Financial Institution
NGO	Non-Governmental Organization
RSCA	Rotating Saving and Credit Association
SA	South Asia

SIDA	Swedish International Development Cooperation Agency
SME	Small and Medium Enterprise
SRI	Socially Responsible Investor/investment
SSA	Sub-Saharan Africa
USAID	U.S Agency for International Development

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Chapter 1

Introduction

1.1 Background

Microfinance has been recognized worldwide as a potential tool to contribute to the alleviation of poverty and promoting economic growth in developing countries. Basically, microcredit is a core service of microfinance; and is known as a small loan provided to those marginalized groups who experience barriers to accessing credit from the mainstream financial sector. Over the last two decades, microfinance institutions (MFIs) have broadened into a wide range of microfinance services, including microcredit, microsaving, microinsurance and remittance services, using innovative methods and modern technologies. This industry has been growing significantly in terms of number of clients, loan volumes, numbers of providers, and the numbers of investors. There are a variety of institutions that distribute and promote microfinance services, currently estimated at over 10,000 throughout the world, including non-government organizations (NGOs), cooperatives, credit unions, housing developers, commercial banks, and rural banks. Notably, the emergence of the nonfinancial institutions, such as telecommunication companies, post offices, and gas stations have contributed to the change and the growth of this industry. Some MFIs even diversify a range of credits; using differing sizes and maturities for different purposes; and expanding to service not only poor but also non-poor (low-income) households.

The high increase in demand from micro and small enterprises (SMEs), low-income and poor households, for financial services for income generating activities, potentially enable MFIs to enlarge their operations. Donor, government and development agencies were previously predominant in providing grants or subsidies, along with technical support, to MFIs. However, the existing funding sources are unsustainable and becoming less able to meet the rapid rise in demand from MFIs; consequently additional sources of funding are sought for long-term up-scaling operations. As a matter of fact, growing numbers of MFIs have transformed themselves from unregulated microfinance NGOs into fully or partially regulated financial institutions in order to mobilize savings from the public where they are authorized, to appeal for more investments from commercial investors, or to get loans from capital markets to achieve financial sustainability.

Noticing the increased needs of MFIs for accessing additional financial resources for their constant growth, individual and institutional investors who are social development-oriented have become more interested and involved in financing this sector. Principally, they can invest either directly in an MFI or through financial intermediaries known as microfinance investment funds. These funds are considered an emerging market, and have played an important role in collecting capital from various types of investors to refinance in diversified MFIs, a unique characteristic that differs from those in developed market. Since the 1990s, funds have been gaining in popularity and growing gradually, matching the progress of the microfinance industry. This can be seen from the increasing of fund assets from US$1 billion in 2005 up to around US$7 billion in 2011, with approximately individual 102 funds globally.

Although sharing a similar purpose is to invest in microfinance, microfinance funds have a variety of legal forms, organizational structures and funding styles. Individually, funds have created policies and strategies that they use as principles and guidance for decision making on investment in any MFIs. Funds have been using different investment base strategies for their objectives and existing sources of funding. For instance, by applying flexible approaches, some large funds have a selection of structured products that they tailor to the need of investors who have different risk-return profiles, as well as to satisfy the particular funding needs of MFIs. Therefore, the emergence of microfinance investment funds not merely plays a vital role in bridging the funding gaps in microfinance sector and improving their sustainability, but also assisting investors to diversify their portfolio, which is better than mere stand alone investment.

Increasing interest and participation of investors, academic researchers, and microfinance investment practitioners has fostered the growth of studies in this sector. Most studies have used quantitative data to evaluate the performance of funds to see whether or not the investment in microfinance adds value to investors, to examine the significant changes in the number of funds, value of assets, trends in use of instruments, currency, regional distribution and so on. However, previous studies have not provided investors and relevant parties with information on the elaborate detail of investment criteria, procedure and investing behavior of the microfinance funds. Additionally, there are very few studies on the text-based information available from microfinance funds, especially from fund websites, to explore what investment strategies are most often explained to the public, and potential investors, to promote the microfinance sector, as well as to sell individual funds. This research attempts to fill this gap.

1.2 Problem of Research

As mentioned earlier, one problem identified from the literature review in section: 3.2 is that there is an immense funding gap in the microfinance sector, and microfinance investment funds have been considered as important vehicles to solve this issue. These funds act as financial intermediaries between investors and MFIs. However, both investors and MFIs wishing to access favorable funds have been restrained by the lack of information on microfinance investment fund behaviors and conditions, such as the methodology of fund managers for MFI investments, including selection criteria, in what terms and instruments are offered, associated risks, etc. The lack of information is compounded by the widely differentiated use of financial instruments, funding styles and objectives; new funds particularly tend to be less publicly accessible and unfamiliar. Indeed, in some developing countries, there are no such funds.

The collective information on the investment strategies of each fund is limited, although there are extensive studies on the performance of MFIs and microfinance investment funds, employing various methods, different datasets for diverse context, and across different study periods. The lack of comprehensive data and the paucity of information on investment policy may have an influence on investment selection strategy, as well as the decision behavior of investors. Investors are likely to remain improperly informed or uninformed. Investors appear to make their decisions on the basis of familiarity. These decisions are made ambiguously or in ignorance, which may lead to misallocation of resources, resulting in inferior returns. This situation suggests a negative effect on investors, and also on MFIs who may lose their opportunities to obtain additional sources of funding as they are unaware of which characteristics are eligible, and cannot optimally prepare themselves to receive financing from microfinance funds. Moreover, the absence of appropriate documentation adds to the general ignorance about investment in microfinance funds, which may form an obstacle to future growth in the industry and the overall economy. This study of the investment strategies of microfinance funds will benefit those who need a better understanding of investment conditions and behavior.

1.3 Objective of Research

The first aim of this research is to theoretically introduce the characteristics of the main players in this sector, microfinance and microfinance investment funds, how they complement each other, and the associated risks and benefits. Due to the availability of data, the main objective of this research is to identify and describe the range of information related to investment strategy which appears on the website of microfinance investment funds, to provide an audience of predominantly fund investors and microfinance institutions with a better understanding of; *how, whom, and where microfinance funds choose to invest, what terms and instruments, the related risks and returns; and for what reasons*. At the same time, the research intends to comprehensively explore the available information and seek hitherto unexplored patterns.

The expectation is that through this study, the particular components of the investment strategies of microfinance funds will be uncovered, and stakeholders informed. This study aims to provide deeper, more transparent and detailed guidelines and investment procedures, i.e. the investment strategy design will be documented as a comprehensive model to contribute to microfinance literature, to be used as deep and effective information to enhance clear perception of microfinance investment. It will provide essential information to inform and assist fund investors to adapt their strategies, to select and to make precise decisions on investment. Additionally, this study seeks to provide more understanding to MFIs, that they may better prepare themselves to access to additional financing resources from microfinance investment funds.

1.4 Research Questions

Given the problems identified above, by studying *textual information on the websites* of microfinance investment funds, this research seeks to explore and to understand investment procedures, selection criteria, basic terms and products offered, descriptions of risk and return, the funding structure of funds and so on. In this context the overall research question of this thesis is: **"how are the investment strategies of microfinance investment funds designed?"**. To answer the research question, the following sub-research questions have been formulated:

1. For what purposes do microfinance funds invest in microfinance?
2. What are the selection criteria for eligible investments?
3. Who are eligible to obtain financing from microfinance funds?
4. What key products and terms are offered to microfinance institutions?
5. What are the investment processes of microfinance funds?
6. What type of investors are attracted?
7. What is the geographic distribution of microfinance funds?
8. What risks and returns come from investments in microfinance?
9. Are key products provided to any eligible partners that are related to their legal form or development stage?

1.5 Scope and Delimitation of Research

This research will pay particular attention to the microfinance sector, especially emphasizing the new emerging microfinance investment funds, by looking at the *textual information on the websites* of the microfinance investment funds, focusing on what fund managers disclose regarding to their investment strategies to motivate microfinance investment. There are many kinds of information that appear on the fund websites, such as video clips of their activities, pictures, diagrams, downloadable files (such as reports and brochures) and so on, however, this study will focus only on *the written information that relates to investment policy of microfinance funds.*

The scope of this research is limited to addressing what kind of information, if any, is provided with respect to the investment strategies of microfinance funds. This research is strengthened through reference to existing literature and previous studies, however the nature of the information available, sourced as it is from the websites of the microfinance funds themselves, limits the extent to which the findings can be generalized. The findings cannot significantly influence decision making of investors, but they can provide significant insight on investment strategies of microfinance funds.

1.6 Data and Methodology of the Research

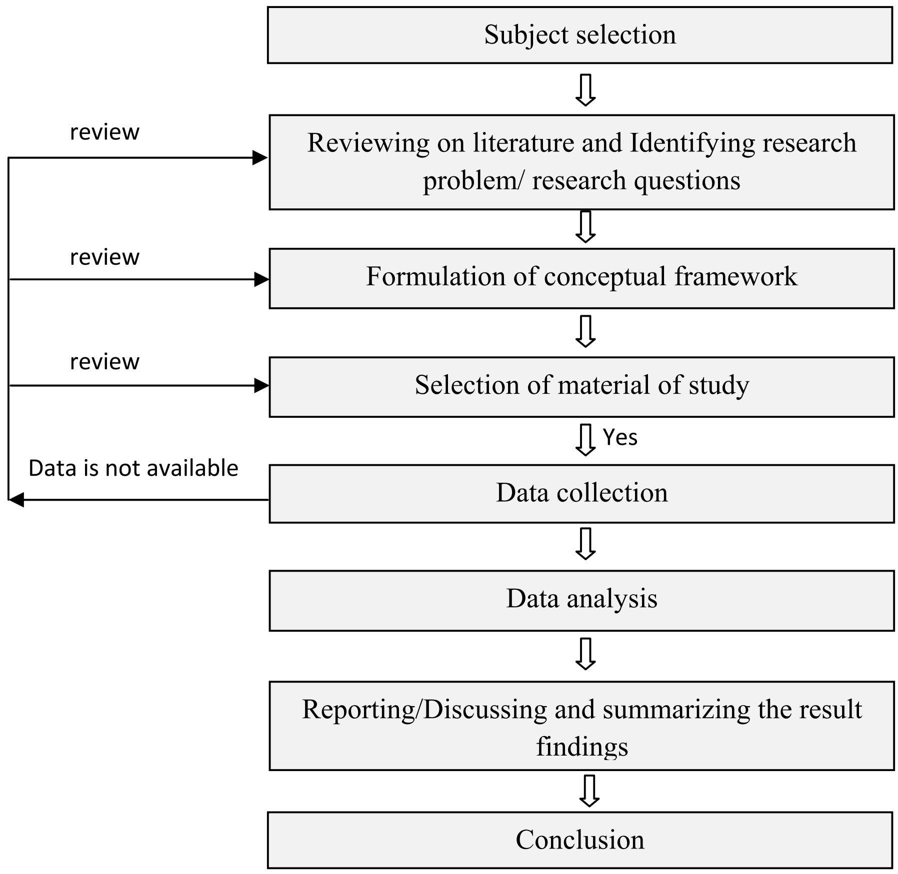
Figure: 1.1 illustrates the methodological process of this research: Once the general topic is determined, the process commences with a review of the literature of microfinance and microfinance investment fund by using various sources, including books, articles, technical reports and websites. Then, the research problem and questions are identified and precisely asked, and after gaining an understanding of the context and issues, the specific topic can be decided upon. The next step is the formulation of a research framework based on the literature review as a research plan in response to the research questions. The third step relates to selecting the material to be studied, the source of the data to be accessed in order to answer the research problem, and subsequently the collection of data.

As the quantitative data related to microfinance funds is difficult to access, the main research problem, and the nature of this research, is to explore the behavior and perception of funds in microfinance investment. Consequently, the qualitative approach is more appropriate in this research. This thesis will use secondary data, textual information to be collected from the websites of microfinance funds. The sample funds will be gathered and selected from the list of microfinance investment funds in MIX Market[1] database.

In step four, data will be analyzed using the content technique. The large amount of textual data will be categorized and collated with the aid of computer software (NVivo.8) to find out the main categories of answer to each question. As this study will investigate the investment strategy performance of microfinance funds, deep quantitative investigation is not necessary; however, a statistical description will be used to discuss the results, identifying similarities and differences with similar prior studies, and to investigate the relative themes. This will be followed by interpreting the empirical results, relating them to existing theories and studies, and summarising the key findings. Finally, research conclusions will be drawn, along with proposals for future research.

[1]The Mix Market is a global microfinance platform which provides information about microfinance in various ways for a variety of stakeholders. Its aim is to promote investment and information flows within the world of microfinance and donors, as well as to improve reporting standards in the microfinance industry, `http://www.mixmarket.org`

Figure 1.1: Research Methodology

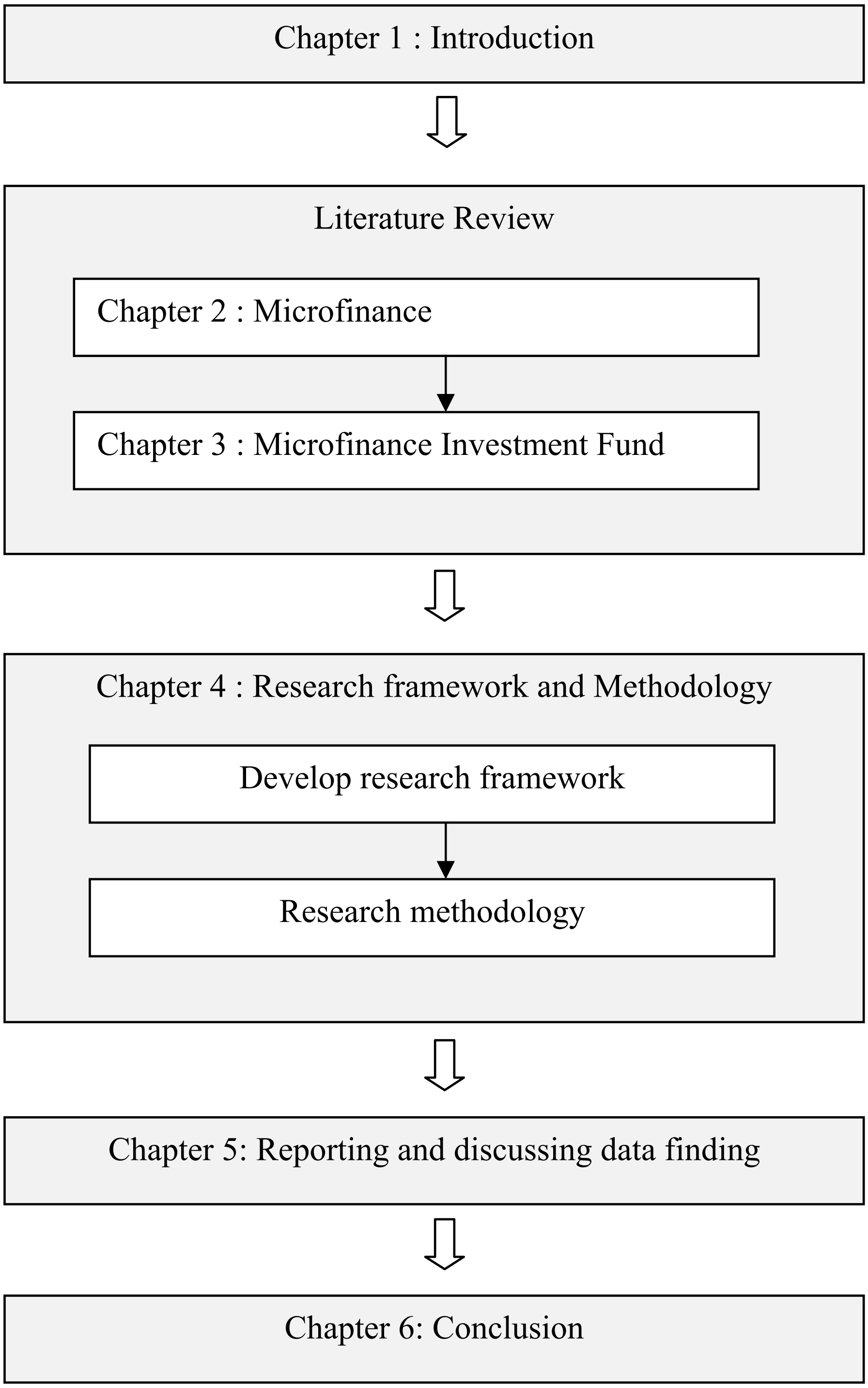


1.7 Outline of the Study

This thesis is organized into six chapters (see Figure: 1.2). Each chapter is designed as an overview of the topic with a response to the research question. It starts with an introduction chapter: 1, which provides an overview of this thesis, including a brief background on microfinance and microfinance investment funds, states the research problem and objectives, introduces the research question and sub-questions, scope and delimitation, and the data and methodology of the research. Chapter: 2 reviews the characteristics of microfinance, introduces the institutions who provide these services, the evolution of the sector, the target groups, financial products and services, and how they are implemented. Following on, chapter: 3 critically reviews the literature of microfinance investment funds, investigates the linkage of microfinance funds to microfinance institutions, and the current issues in the microfinance sector. It also discusses the financial instruments which are usually used in microfinance investment, the investors in these funds, the of microfinance funds, and the risks associated in microfinance investment.benefits

Chapter: 4 describes the research framework which can be established, relying on the research problem and existing literature, and determines clearer and narrower research questions and sub-questions. This chapter also presents the research methodology, which introduces the theoretical data analysis technique and its real application. The qualitative content technique will be applied to analyze the collected data, exploring the nature of investment and revealing new information. Reporting and discussing the findings are made in Chapter: 5. The empirical results under each research question are identified, described and interpreted with quoting a unit of text in collected data confirming the conclusion. Since the data can be collated and analyzed using statistical techniques, they are also discussed by linking to the similar previous studies which generally used quantitative data. A chi-square model will be used to test the relationship between investigated variables to answer the research questions. Before going to the last Chapter: 6, contains a summary of the key findings, observations on the degree of variation from previous studies, and highlighting useful new information. Conclusions are drawn, based on the previous chapters. This study concludes with a note on the limitations and suggestion for future research.

Figure 1.2: Outline of the Study



CHAPTER 2

Literature Review: Microfinance

Having introduced the problem and the purpose of this research in chapter: 1, it is necessary to overview the literature of microfinance. The aim of this chapter is to present the features, service providers, and products and services within the microfinance industry. We begin with a definition of microfinance and its main characteristics in section: 2.1, followed by section: 2.2 which defines and classifies service providers into different categories. Section: 2.3 introduces a history of microfinance, and examines its continuous growth in terms of the number of lending institutions and microloan borrowers, and the size of the outstanding loan portfolio; the factors contributing to growth; and the industry's current challenges. The target clients of microfinance, and the different sorts of financial products and services of microfinance, including microcredit, microsaving, microinsurance, and payment services are described in section: 2.4. The last section: 2.5, addresses the current interest rates that microfinance institutions lend at, and what factors determine those rates.

2.1 What is Microfinance?

Microfinance is not a new term. Initially, it was developed as a method of supplying short-term credit, with the requirement of collateral substitutes from borrowers (CGAP, 2003). Microcredit is the most well known microfinance product, but microfinance has now extended to offer more services, requiring a broader definition. Current definitions of microfinance vary from time to time depending on the industry players and their objectives. Today, microfinance refers to the provision of a wide range of financial services, such as microcredit, microsaving, microinsurance and fund transfers to poor and low-income clients for consumption or self-employment (ADB, 2000). The simple term "banking for the poor" covers provision of these kind of services (Khandelwala, 2007). Elsewhere, Ledgerwood (1999) defines microfinance as an economic development approach intended to benefit low-income women and men.

In India in 1999, the Task Force[2] defined microfinance as the "provision of very small amounts of thrift, credit and others to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standard". We can confidently say that microfinance has always been available to assist in sustainably delivering financial services to poor and the near-poor households (micro entrepreneurs) who are excluded from formal financial services, thus ensuring permanent access to appropriate high range financial services with affordable service charges. Consequently, microfinance is a well-crafted tool for assisting micro entrepreneurs to run and expand their businesses (Madurai, 2003).

Alternatively, Brandsma & Burjorjee (2004) identifies the main characteristics of microfinance by focusing on lending for income generation:

- Targeted to the entrepreneurial poor: the provision of financial services to low-income clients, those who are unable to access credit from other financial institutions, in order to create or expand their business.

[2]Task Force was constituted by NABARD under the Chairmanship of Shri Y. C. Nanda, Managing Director, NABARD and other members, to work out a conceptual framework for a national policy on microfinance

- The nature of the loan is small, short-term, with frequent repayments, repeated, simple, and convenient.
- Using collateral substitutes, for example, group guarantees, dynamic incentive, or compulsory savings to prompt repayments.

Microfinance not only involves accessing and distributing money, but it engages deeper in the way that money is used, invested, and saved. It generally provides capacity building for those using their services, including organizational and operational aspects, leadership development, trust building, small enterprise management, cash management and information transfer, etc. This kind of capacity building improves self-confidence, provides new opportunities to encourage clients to be more confident in participating in economic, social and political activities. Microfinance integrates the financial needs of poor and low-income people into a country's mainstream financial system, aiming to help them to raise income, build up assets and/or protect themselves against external shocks. Therefore, it plays vital role both financially and socially, since it has evolved as an economic development approach intended to raise clients out of poverty.

2.2 What is a Microfinance Institution (MFI)?

The term "microfinance institution (MFI)" refers to an organization that offers microfinance services. In economics terms, a microfinance institution works as a poverty-focused financial institution to offer financial services to a segment of the population who are not being served by mainstream financial services providers, aiming to increase their living standard. These definitions not only indicate the scope of microfinance per se but also point out the need to balance between the social and financial objectives of microfinance (Madurai, 2003).

Generally, MFIs provide small credit at reasonable interest rates to poor and low-income families, micro entrepreneurs, and the self-employed such as market vendors, taxi drivers, farmers, etc., who are unable to get a loan from traditional banks due to lack of collateral and credit history.

Through microloans provided by MFIs, borrowers are able to invest in income generating activities, to increase revenues, and thereby improve the standard of living for their family. As small businesses grow, they often offer employment to other people in the community. In this view, microfinance institutions play a role that complements the banking system, by developing innovative lending techniques, including joint-liability lending, flexible repayment loans, tiny loans with dynamic incentive[3], progressive lending and frequent repayment installments etc., to lend to borrowers whom the banks view as too costly or too risky to reach.

MFIs deliver other services, including micro-insurances which provide a financial cushion in case of sickness, death or disaster; micro-savings, which are also extremely important for providing a secure place for clients to save money to cover emergencies, to build better homes or to educate their children; and payment and remittance services which adapt to modern technologies. MFIs may differ in term of vision, size, and legal structure, and they are found in many forms such as credit unions, cooperatives, non-bank financial institutions (NBFI), and often non-government organizations (NGOs). Some financial sectors such as state-owned postal, development and agricultural banks are also active in microfinance activities.

[3]Dynamic incentive refers to conditioning new loans on full repayment of previous ones, requiring borrowers to deposit a percentage of the loan, group knowledge of borrowers' repayment capacity, and social pressure for repayment

Types of Microfinance Service Providers

Churchill & Frankiewicz (2006), classifies microfinance service providers into three main types, based on an analysis of the financial landscape: formal, semi-formal, and informal MFIs; the distinguishing factors among them is the degree to which they are overseen by external entities or authorities.

(a) ***Formal microfinance service providers***: Formal institutions are the most recent entrants into the microfinance sector. These institutions may be publicly or privately owned and exhibit a variety of objectives, experiences and approaches. Their services consist of savings or credit offerings that serve a large or small population in rural or urban areas. Private institutions generally focus on urban areas, whereas public institutions provide services in both urban and rural areas. In the modern industrial sector, private institutions typically mobilize saving and provide large amount loans to individuals, usually to large, established companies, either private or government-owned. By contrast, rural public institutions often provide loans for agricultural productivity. All formal institutions are regulated, most are profitable, and are financed by foreign capital, government subsidies, and deposit taking.

    This type of institution is broken down into four categories: 1) private commercial banks, 2) development banks, 3) saving banks, and 4) non-bank financial institutions (NBFIs). The processing of loan lending is time consuming, since it requires paperwork and bureaucratic procedures that result in high transaction costs. They use a business-like approach to achieve cost recovery in lending operations (Ledgerwood, 1999). However, the lending practices of formal MFIs are often not suitable for small enterprises and low-income borrowers, as many micro business owners do not have sufficient collateral, or proper financial reporting systems, or fail to meet other requirements.

(b) ***Semi-formal microfinance service providers***: These are registered entities subject to general laws, but not subject to oversight by a banking or finance authority. The three main categories are microfinance NGOs, credit unions[4] and saving and credit cooperatives (SCCOs)[5]. Private companies that provide short-term credit, cheque cashing services or money transfer facilities can be also included in this category. (see Table: 2.1). Generally, their main strengths are their abilities and motivations to achieve deep outreach by providing financial products and services in an area somewhere between those offered by formal and informal institutions. Semi-formal institutions in many countries are often funded from donor grants and government subsidies, with external technical assistance to support their operations (Ledgerwood, 1999). Credit unions are able to capture savings, giving them an important source of financing: the ability to leverage their equity.

(c) ***Informal microfinance service providers***: These are typically outside the structure of government and are monitored only by their members. They do not have financial recording standards and are not included in official statistics on the depth and breadth of the country's financial sector (Ledgerwood, 1999). They can be classified into three categories: 1) indigenous groups, such as ROSCAs[6], ASCAs[7], and burial societies; 2)

[4]A credit union is a member-based entity that is controlled and managed by its members. Their aim is to to promote thrift, to provide credit at competitive rates, and to offer other financial services to members. The members who have accounts in the credit union are the owners

[5]SCCOs are a type of cooperative whose objective is to mobilize savings for members and in turn provide them with credit facilities.

[6]ROSCAs: Rotating saving and credit associations, which usually comprise of between five and fifty members, who are primarily female. ROSCAs do not charge or pay interest on loans. They offer little flexibility, since the payout is a defined amount that can only be obtained on the singular occasion when one ?wins? the fund.

[7]ASCAs: Accumulating Saving and Credit Association: like ROSCAs, comprise of approximately 30 members, mainly women. The cash that flows through an ASCA can accumulate, rather than be liquidated at each meeting as in a ROSCA. If the fund is too small to attract a borrower, it must be stored temporarily. This is more flexible, but also more complex and more risky than the ROSCA

externally promoted self-help groups, such as village banks and financial service association (FSAs)[8]; and 3) private entrepreneurs, including individual money lenders and pawn shops. The borrowers in this type can get loans quicker with a minimum of bureaucratic procedure. Loan approval is based on personal knowledge of the borrowers rather than on a sophisticated feasibility analysis, without formal collateral and usually with very high interest rates. However, loans from moneylenders are often not taken for productive purposes but rather for emergency or consumption smoothing. Loan lending i.e. money lenders and shopkeepers, is usually for a relatively short period of time.

Table 2.1: Three Main Types of Microfinance Service Provider

Formal	Semiformal	Informal
1. Commercial bank 2. Development banks 3. Saving banks 4. NBFI Finance companies Leasing companies Insurance companies	1. NGOs 2. Credit unions 3. Savings and credit cooperatives 4. Private companies	1. Indigenous group ROSCAs ASCAs 2. Self-help group Village bank FSAs 3. Private entrepreneurs Pawn shops Moneylenders

(*Source: Craig Churchill and Cheryl Frankiewicz, "Making microfinance work," 2006*)

[8]FSAs resemble village banks without the link to external loans. The model emphasizes equity rather than savings as the main financing mechanism

2.3 Evolution of Microfinance Industry

Microfinance was found in ancient times, as the idea of granting loans developed over thousands years; the Jewish community, for example, lending to the poorest among them. Microfinance notably had its roots in micro-lending, and started within non-governmental organizations with social and development objectives of fighting against poverty and "empowering" the marginalized. The first experiments on microfinance models was been conducted in Burkina Faso and Cameroon in the sixties, where savings and credits models appeared, but only for social action (Ayayi et al., 2007). In the seventies, government and international donors provided cheap productive credit to the poor, particularly small farmers and those who had no previous access to credit facilities, aiming to promote agricultural products.

In the 20^{th} Century, microfinance has taken off gradually. Microfinance pioneers shifted into providing loans to "non-farm enterprises", small entrepreneurs who had no capital to start a small business (street vending, rice trading, home handicrafts, livestock-raising, etc.), or to those who had been forced to pay usurious interest rates, without asking for collateral to secure loans. The success and the constant growth of microfinance benefited greatly from the new lending practices under the peer group micro-lending (also called Joint-Liability lending) model of the Grameen Bank[9] in Bangladesh. Prof. Mohammed Yunus, the founder of Grameen Bank, applied the methods of a pilot group lending scheme for the poorest women and landless people that was notably successful, with profits and low credit risks.

The group lending of Grameen Bank was a major source of new formal

[9] Grameen Bank project was originated in the village of Jobra, Bangladesh, in 1976. The project was transformed into a formal bank called "Grameen Bank" under a special law passed for its creation in 1983. GB has reversed conventional banking practice by providing credit without collateral to the poorest of the poor in rural Bangladesh.

microcredit lending techniques which were then copied and taken by MFIs to be used in countries such as Cambodia, Nepal, and Philippines, etc. In those developing countries NGOs were major microfinance service providers to the poor in remote areas. For instance, in Latin America, ACCION International supported the development of solidarity group lending to urban vendors, and Fundacion Carvajal developed a successful credit and training system for individual micro-entrepreneurs. Given this favorable experience, there was an increase in the number of microcredit providers not only within developing countries but also in developed countries. For example, Agency for Development and Economic Initiative (ADIE) and Active Network France in France, under the leadership of the Microfinanza in Italy, and Finnvera in Finland.

The number of MFIs and clients worldwide has been constantly growing over the last three decades, there are now more than 10,000 MFIs globally, in more than 85 countries, range of types such as credit unions, NGOs, cooperatives, government agencies, private and commercial banks and so on. These MFIs currently serve over 100 million clients worldwide, of whom 71% are women (Dieckmann, 2007). Women are the main target client in microfinance since women are reported to have a better understanding of finance, take more responsibility on credit and have better repayment behavior. Lützenkirchen et al. (2012) found 74% of all clients are women, while women make up 82% of the poorest clients.

According to data obtained from the database of MIX market[10], the total number of active MFI borrowers was 94.7 million in 2011, compared to 71.7 million in 2007. During the 5 year period from 2007 to 2011, the number of

[10] Data obtained from dataset in MIX Market, http://www.mixmarket.org. Data for the period 2003 to 2007 was retrieved on July 2011, and data for 2011 retrieved in January 2013. MIX only reports on the MFIs from whom they receive data. To accurately asses the scale of the microfinance industry is difficult due to the data weaknesses and conflicts previously mentioned.

people using credit from MFIs increased around 32% (1.3 times the number in 2007) a slower increase than the previous 5 years, 2003 to 2007, which rose at 81% (numbers in 2007 had mostly tripled, 2.8 times the number in 2005). In addition, the total gross loan portfolio swelled over 100% from US$38 billion in 2007 to US$86.8 billion in 2011, a growth rate of 26 percent per year during this period. Remarkably, the mobilization of public savings grew sharply, up 243% in 2011 (over 3 times) compared to 2007 (see Figure 2.1). There was a significant increase in new entrants to the microfinance market in each continent, as the total number of MFIs reached 2,807. Figure 2.2 illustrates the rise in numbers of MFIs in each region for the year of 2007 and 2011. The major increases were in Africa, about 2.4 times, followed by East Asia and the Pacific (1.9 times), and South Asia (1.7 times). The number of MFIs in other regions also grew, but at a rate slower than these three regions.

Furthermore, the evidence of evolution in the microfinance industry is reported by the significant growth of MFIs in developing countries: more MFIs, more clients and the expansion and innovation of available financial products and services. For instance, in Cambodia in 2011 there were 23 MFIs operating, with 1.4 million borrowers and a loan portfolio of US$1.6 billion[11]. As seen in Figure 2.3; the microfinance market in this country expanded at historic rates with increases in gross loan portfolio and deposit mobilization growing around 49 percent and 50 percent per year respectively between 2007 and 2011. The same year, in Bangladesh, 81 MFIs reached 20.9 million borrowers, with gross loans of US$2.2 billion. Given this level of growth in the global microfinance industry, many microfinance practitioners and analysts agree that microfinance is a significant tool to promote financial services for the poor, low-income households and small business owners.

[11]Data obtained from MIX Market, http://www.mixmarket.org/mfi/country/Cambodia

Figure 2.1: Growth of Micro Borrowers and Loan Portfolio 2003 - 2011

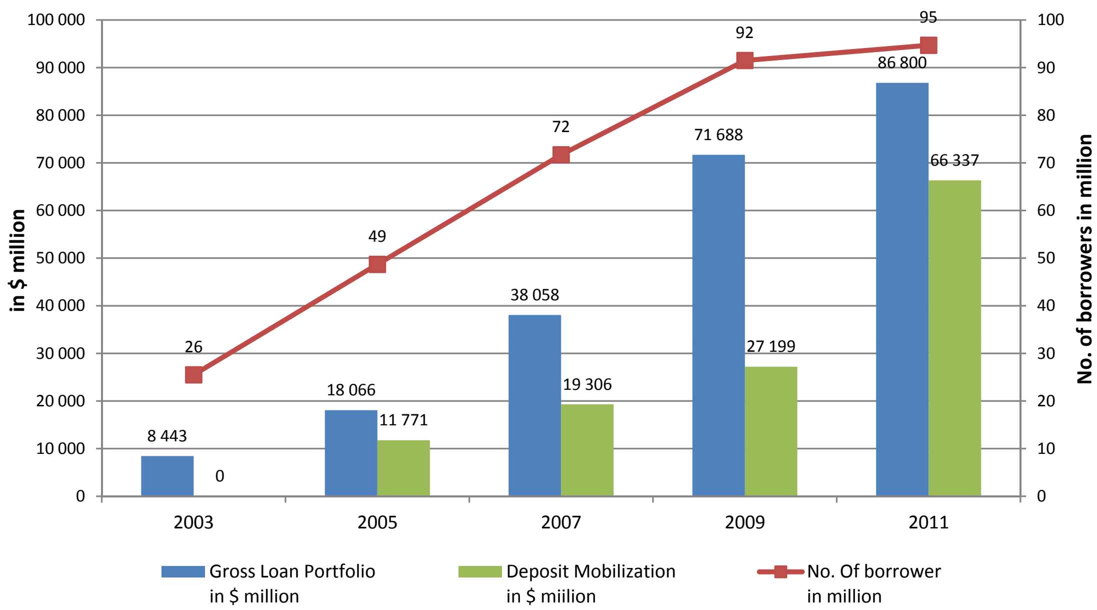


Figure 2.2: The Number of MFIs by Region

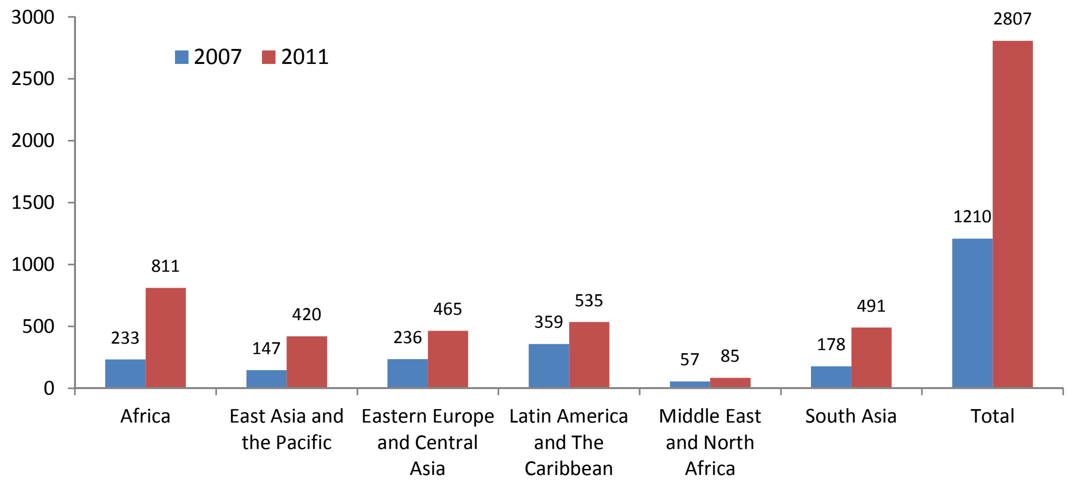
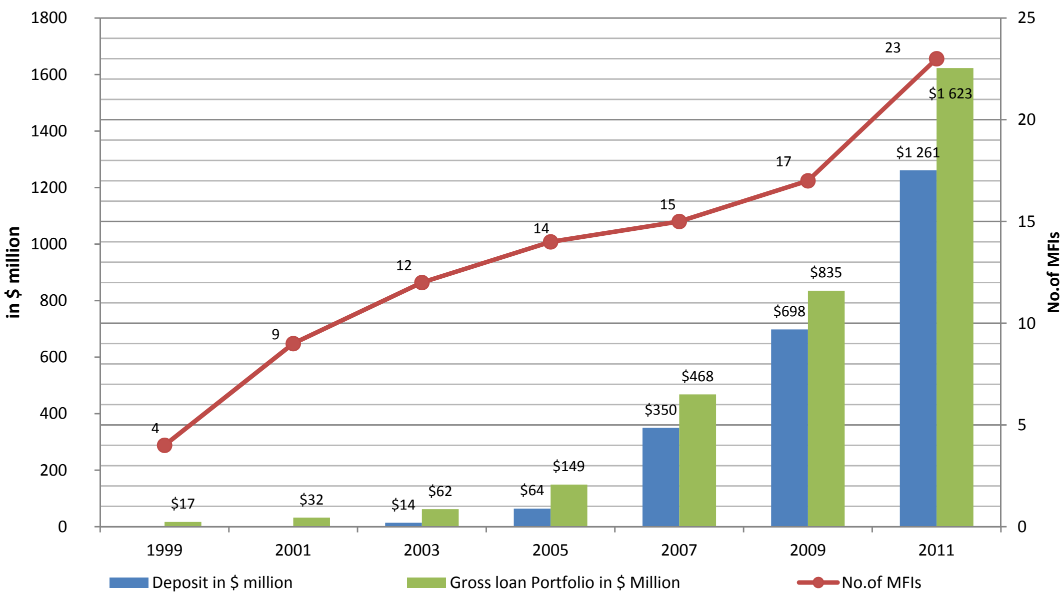


Figure 2.3: The Growth of MFIs in Cambodia



(*Source of data retrieved from MIX*)

The growth of microfinance coincides with an expansion into new markets and regions. Particularly, regulated and sustainable MFIs have increasingly expanded to serve in urban areas, switching their target group from low-income to more affluent clients, some even focusing on this group from the outset. Individual lending of this type has become a more common offering because it is more convenient to apply in urban areas and with wealthier clients who prefer individual contracts. In urban areas, microfinance institutions lending to higher income clients achieved over 60% market share, and nearly 50% for lower income clients. On an individual lending technique basis, the higher income clients receive microloans from MFIs more than 90% and lower income clients more than 50% (Lützenkirchen et al., 2012).

Several studies show that the modern microfinance industry have been continuously changing and developing for several reasons: microfinance NGOs and MFIs have been innovating existing financial products and services to achieve greater effectiveness and efficiency. In fact, the introducing of lending techniques, including individual lending, group lending and dynamic incentives aims to encourage loan discipline in order to obtain high repayment rates, reduce default rates, and increase the amount of repeat loans. As result, the top MFIs achieved repayment rates of 98 percent and higher, since their borrowers could generate a fairly steady income. This technique also seeks to mobilize saving from borrowers as collateral, to provide saving services that meet the needs of small savers. Moreover, this approach is designed to motivate staff to achieve greater outreach, with better loan repayment rates, and to reduce transaction costs by shifting some of these costs to the group level. For example, Bank Rakyat in Indonesia developed a transparent set of incentives for its borrowers (small farmers) and staff, rewarding on-time loan repayment and relying on voluntary saving mobilization as a source of loan lending.

Contrastingly, some MFIs operate in similar way to the traditional system (rotating saving and credit association) but with innovative techniques, better flexibility, at more affordable prices and on a more sustainable basis to a large number of low-income clients and small and medium enterprises. The increasing number of success stories involving innovative microfinance activities, both in terms of operations and regions, are well-documented, and continuously studied and copied, leading to wider implementation, albeit with variations, and the continued growth of institutions (Ledgerwood, 1999). The goal of reaching the poor and under-served groups is also one of factors that grows the microfinance sector. Favorable outcomes from loan lending (microborrowers have a better living standard and may become financially-self sufficient) and the high increase in demand for microcredit have potentially led existing MFIs to scale-up their lending operations, and have fostered the establishment of new entrants into this sector.

Similarly, the existing formal financial system, including such organizations as saving and loan cooperatives, credit union networks, commercial banks, and even state-run financial institutions are increasingly diversifying their products and services, to become more demand-driven, and this often involves providing microfinance services. ICICI bank [12] is one commercial bank involved in microfinance, and is expanding its financial services to poor households through a multi-pronged approach that includes providing direct credit facilities to self-help groups, and by funding wholesale credit facilities to microfinance NGOs and nonbank finance companies for their lending operations to the poor. Other notable examples are the ANZ's rural banking program in Fiji, and Sri Lanka's Hatton National Bank's attempts to serve poor rural households.

Malaysia, Nepal and Thailand also have programs that stimulate commercial banks to participate in microfinance. Furthermore, the gradual transformation of institutions from donor-oriented model into formal regulated financial institutions enables them to be more professional and to broaden their own operations. ACLEDA Bank and AMRET in Cambodia, and Share Microfin Ltd. in India were formerly microfinance NGOs which have already transformed themselves into regulated MFIs. Meanwhile, the microfinance industry in countries such as the Philippines, Sri Lanka, Pakistan, and Vietnam, etc., have been growing partly due to the increase in the establishment of new microfinance banks and the increasing role of cooperatives, which is paramount in providing facilities for saving and extending credit to low-income groups in such countries.

Lastly, non-financial companies in some countries have also entered into the microfinance market in various ways. Successful cell-phone-based microfinance programs are found in developing countries such as the Philippines, Pakistan

[12] ICICI formerly Industrial Credit and Investment Corporation in India, the country's second largest commercial bank

and South Africa etc. For instance, Globe Telecommunication and Smart Telecommunication in the Philippines have been working with a number of rural banks to use cell-phone based loan disbursement and recoveries, as well as offering cell-phone based money transfer and payment services to their clients. "Several studies by ICT4D[13] researchers in Pakistan and other developing countries have concluded that the use of cell phones has helped reduce poverty and improved the incomes of small vendors, beauticians, fishermen, taxi drivers, delivery people and small shopkeepers" (AVGO, 2010). The entry of non-financial companies has also brought other non-financial institutions like gas stations, pharmacies, grocery stores, and fast-food outlets into the microfinance institutional landscape.

2.3.1 Segmentation of Microfinance Institutions

Microfinance institutions are segmented differently. CGAP (2007a) breaks up microfinance institution into 3 tiers based on total assets. Top tier MFIs are entities that have more than US$30 million in assets. MFIs with total assets between US$5 million and US$30 million make up tier 2, with tier 3 holding total assets under US$5 million. Alternatively, Meehan (2004) classifies MFIs into 4 tiers, depending on their degree of commercialization, ranging from formal institutions as the most developed and fully regulated, to the start-up and small NGOs that accommodate fewer clients (see Figure 2.4).

Tier 1: The number of MFIs in this tier is around 2% of the whole. Most tier 1 MFIs have already transformed themselves into more formal structures, serving a vast number of borrowers and also holding large assets. They are mature and the best known MFIs, with strong financial and operational track

[13]ICT4D-Information and Communication Technologies for Development refers to the use of Information and Communication Technologies (ICTs) in the fields of socioeconomic development, international development and human rights

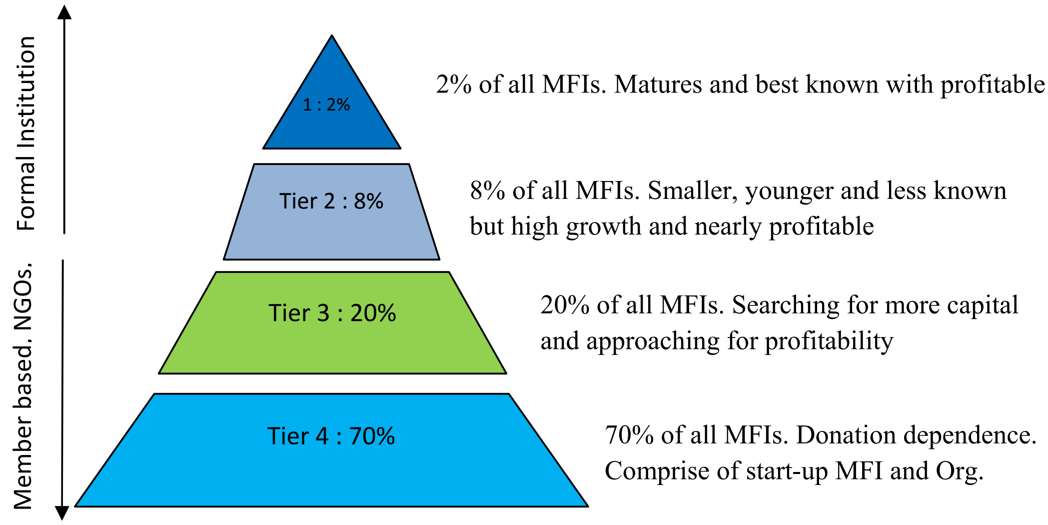
records, which are the main factors to progressively attract investment from commercial banks, institutional, and individual investors. Because top tier MFIs are usually profitable and have more management experiences, private investors consider them as the most suitable institutions to absorb commercial funding for effectively re-lending to micro-borrowers. The most advanced MFIs collect domestic savings, and use debt financing; some even issue bonds into capital markets, or securitize their loan portfolio (Dieckmann, 2008). Some financially sustainable top tier MFIs, that need neither subsidies from donors nor external funding from investors, are the latest challenges for investors.

Tier 2: Around 8% of MFIs are included in this tier. Compared to the top tier, the tier 2 MFIs are smaller, younger and less known, but high growth and nearly as profitable. Most of them are NGOs in the process of transforming themselves into regulated MFIs. They receive debt financing from investors both local and international, both public and institutional.

Tier 3: MFIs in tier 3 make up about 20% of the total number. All MFIs which fail to meet the required standard due to immaturity, weak management information systems, lack of capital or other requirements are identified as tier 3. They are approaching profitability, searching for more capital due to a lack of funding.

Tier 4: The remaining 70% of all MFIs are grouped in tier 4, which consists of start-up or informal financial institutions which are weak and not primarily focused on microfinance. The start-up MFIs depend largely on donations in the form of equity grants with the support of technical assistance (Dieckmann, 2008). Most tier 4 MFIs are less appealing to private investors, while the top ones are the most attractive due to their degree of outreach and the size of their loan portfolios (Galema & Lensink, 2009).

Figure 2.4: Segmentation of Microfinance Institution



(*Source: Jannifer Meehan ¨Tapping Financial Market for Microfinance¨ October, 2004*)

2.3.2 Source of Funding in Microfinance Institutions

Traditionally MFIs are founded as non-profit oriented organizations with a social objective that focuses on assisting the poor to access credit or savings. Institutions have financed their activities mainly with grants, subsidies, loan guarantees, and concessional loans[14] from local government, local and international donor and development agencies who seek to provide financial services to destitute people, the poor and low income households. These funds are primarily needed in the early stages of MFIs to support payment of salaries, staff capacity building and organizational development.

Public and soft funding have played a significant role in financing MFIs to support their operations. Over time, access to these funds is not sufficiently sustainable to support financial services, and will likely place limits on an institution's ability to meet the higher demands of financing that come from

[14]refers to loans to poor countries with low interest rates and longer repayment periods

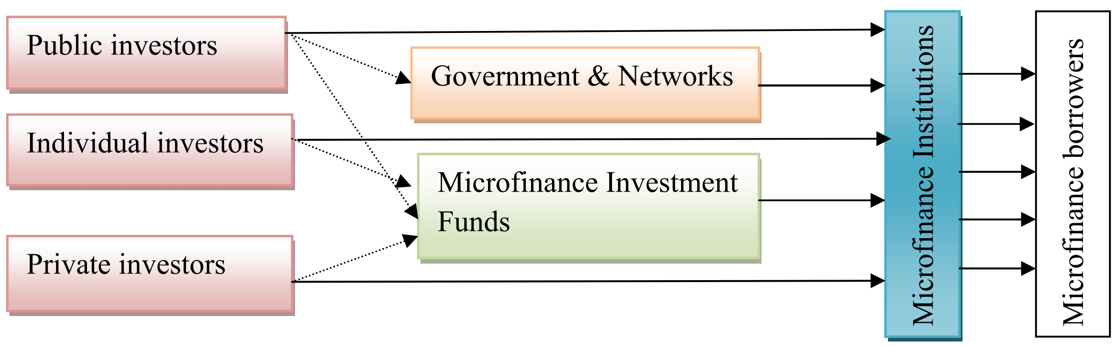
the rapid up-scaling in today's industry . As donor funding is becoming less available to meet the increase in demand for microfinance providers to further expand loans, innovate financial products for better design and delivery, it is essential that MFIs seek additional sources, in order to grow their portfolio and avoid problems of financial shortages.

Remarkably, certain institutions have found a wider range of funding sources, including savings mobilization and commercial borrowing, and some even issue securities or bonds into the capital market. Some well-managed MFIs have integrated more into mainstream finance, and aimed to promote more commercial investments in microfinance i.e. by leveraging public funding to attract private funds. Microfinance has already created interest among potential investors through connecting to the capital markets, generating awareness of microfinance services and by increasingly promoting the commercial viability of MFIs. Most MFIs desire to transform themselves from often inefficient NGOs funded by traditional funds into regulated financial institutions funded by private capital, in order to expand their financing sources and to increase financial sustainability. In fact, more and more top MFIs (tier 1) that are well-managed and less exposed to external shocks such as as bank runs (currency risk and macroeconomic crises) strengthen their financial structures to create positive returns which are nearly twice as profitable as the leading commercial banks in their local environment, thus increasingly attracting the interest of investors (Littlefield & Holman, 2005).

MFIs can get either direct or indirect financing from various types of investor (see examples of foreign investment in microfinance in Figure: 2.5). Going to the public for further accessing alternative financial resource is one of the success stories for advanced MFIs. Banco Compartamos in Mexico was a pioneer in this strategy, issuing a $68 million local-currency microfinance bond in 2002, and was subsequently listed on the Mexican Stock Exchange in a highly successful

IPO in April 2007 (Krauss & Walter, 2008). Notably, some MFIs seeking foreign capital investment are incapable of accessing it locally due to weak operations in local capital markets (Reddy, 2007). However, domestic funding is the principal sources for long-term activities. As Köhn & Jainzik (2005) states, in order to achieve financial sustainability without external support over the longer term, MFIs have to mobilize capital from their domestic markets (savings, bonds and equity).

Figure 2.5: Landscape of Foreign Investment in Microfinance



(*Source: Xavier Reille and Sarah Forster, "Foreign Capital Investment in Microfinance" CGAP, 2008*)

Source: Xavier Reille and Sarah Forster, "Foreign Capital Investment in Microfinance" CGAP, 2008

Meanwhile, some formal MFIs countries have begun to mobilize savings after discovering that savings is an important funding source of domestic capital. It has no currency risk, is more stable, and is a cheaper cost of funding. Many believe that savings mobilization from local depositors to be the largest source of capital for microfinance: 41% of all assets, while foreign capital provided only 22%. Hence capital raised by deposit taking is ultimately crucial for the healthy development of the microfinance sector (Reddy, 2007). There are increasing numbers of institutions providing deposit services on a large scale. Grameen Bank in Bangladesh for example now offers a savings facility that enables members to deposit and withdraw at will. In addition, the bank has introduced a contractual savings account called the Grameen Pension Scheme, with 5 or 10 year terms for members. These deposit services have enabled MFIs to mobilize vast resources and to become true financial intermediaries. The number of deposit mobilizing MFIs (MFIs that mobilized voluntary deposits, excluding MFIs that only mobilize compulsory deposits or institutional deposits) in 2007 was 1.1 times higher than in 2005 (Gonzalez & Meyer, 2009). Clients as well get a huge benefit from this kind of service as they are able to use deposit accounts as an effective means to reduce income volatility (Dieckmann, 2008).

Most MFIs have attempted to diversify their menu of saving products to satisfy rising demand. Through saving functions, MFIs serve as intermediary institutions to distribute local capital from a bulk of deposit amounts of non-poor to serve the poor. However, not all MFIs are entitled to take public deposits from clients. In some countries only regulated MFIs are allowed to take public deposits. In fact, EDPYMEs[15] in Peru was forced to seek alternative capital resources besides savings mobilization due to the practice being authorized. In most case microfinance NGOs are not allowed to collect public deposits; they may revolutionize and improve their internal process by offering new financial products once they need more funding sources. These matters depend on the legal form, size and scope of the operation. A MFI generally use different sources of funding, including borrowing, equity capital, grants and deposit. The main funding tools include equity, debt instruments (senior debt, subordinated debt and junior tranche), securitization of loan portfolios, etc., which are discussed in the section: 3.5.

[15]EDPYMEs : Empresa de Desarrollo de la Pequena y Micro Empresa, the Peruvian Small Business and Micro-enterprise Development Agency Project

2.3.3 Microfinance towards Commercialization

MFIs are beginning to commercialize capital collection by looking to the commercial sector as a non-traditional source of funding, to give out loans in larger amounts and to expand their operations. The increase in demand for microfinance services results in a big gap between demand and supply of funding in this new industry. Since the source of financing is a major concern for MFIs, they are forced to look elsewhere to further fund their portfolios. Commercial-oriented sources can complete this gap, and also support the longer term viability of a fund. MFIs can become commercial-oriented organizations by transforming their legal status from unregulated non-profit or non-governmental organizations into regulated for-profit MFIs, or through the transformation of MFIs into commercial banks with the precise objective of providing financial services to poor people for the purposes of social development. These transformations provide good opportunities to attract more commercial funding either in the form of loans or equity capital.

Microfinance is considered a social-mission-oriented activity that could be also developed into a commercial operation and be operated on a commercial basis. It is believed that commercial-driven MFIs have incentives to increase efficiency. Christen (as cited in Oliva-Beltrán, 2008) defines the commercialization in microfinance as the movement out of the donor dependent arena towards the formal and more sustainable financial sector. However, there is much debate about whether to keep microfinance as a philanthropic business relying on donor funds or development agencies, or to allow them to become commercially viable business which gain more alternative funding sources through commercial borrowing (Dieckmann, 2008). There is some concern that the commercialization of microfinance could lead to a drift away from the mission of serving the large poor population by focusing instead on wealthier clients for profit-making. Nobel laureate Dr. Yunus has warned about the consequences of a further commercialization of microfinance. Nevertheless, the current funding gap cannot be filled without the increasing participation of "social-consciousness-driven" private investors, with a careful balance between social and financial return (Dieckmann, 2008). Studies have found that MFIs can operate commercially without violating their mission, although many are starting to increase lending to wealthier borrowers in urban areas.

Commercial MFIs intend to be profitable. The increasing commercialization of microfinance institutions has promoted the growth of microfinance industry. Commercialized MFIs attract both local and international investors, particularly those who wish to invest with social responsibility, who want to contribute to social development and obtain a reasonable financial return from their investments. Most mature MFIs have more opportunities to access different sources of funding, from short-term methods such as savings deposits to the more long-term fixed-rate bond. Entering into the commercial sector has made the microfinance industry more competitive. Competition and commercialization have led MFIs to become more efficient. Most leading MFIs have managed to reduce their operating expense ratios (OERs) significantly in recent years (Fernando, 2007b). Meanwhile, the increasing of competition leads to declining portfolio yields and better control over operating expenses. Strong competition is also good news for microfinance borrowers who may get loans with lower interest rates, but this is a disadvantage for MFIs whose profitability may be squeezed or impeded. Lower profitability may result in a decreased ability to repay investors' loans, and become less attractive to investors.

Some advanced MFIs have begun cautiously to access borrowing from capital markets, but this has not been widely replicated. This orientation develops a small but energetic market for commercial capital providers which includes both debt and equity opportunities. Still, the microfinance industry has undergone a transformation to be fully integrated into the broader commercial financial system. Significant changes have taken place in microfinance, and a small core group of highly commercial entities have reported much better profitability in terms of ROAs and ROEs than conventional financial institutions. But there is still big difference between the leading tier of MFIs and the rest, as large capital investments flow into the top tier.

2.3.4 Development Stage of Microfinance Sector

According to the work of Kooi (2001), Brandsma & Burjorjee (2004), and Latifee (2006), the development of MFIs has gone through four broad stages, from being merely loan programs to becoming regulated financial institutions. There stages are start-up, expansion, consolidation and integration.

1^{st}**, Start-up stage**: An MFI generally begins with an independent microloan project or a development program by an established NGO. Most microfinance activities (credit and saving) are subsidized by donors and governments. This initial and experimental stage focuses on building both confidence and the capacity of products and clients. The organizational and institutional structure is created to strengthen the program to better cater to the poor, micro entrepreneurs or vulnerable groups, with or without vocational training.

2^{nd}**, Expansion stage**: Branches are created in other regions, more staff are employed, and product development diversifies to meet increasing client demand. Expansion may lead to improved efficiency, decreasing transaction costs and improving economies of scale. MFIs in this stage continue to upgrade and improve their organizational structures, credit policies, regulation compatibility etc., to capture an increasing share of their potential market. MFIs concentrate on mobilizing financial resources to finance the expansion of their activities, while still receiving grants, subsidies and income from interest.

By the completion of this phase, MFIs have captured a large part of the market with the existing product.

3^{rd}**, Consolidation stage**: MFIs focus attention on institutional reinforcement and formulation. Economic of scale and scope must be improved to increase productivity; pricing policies must be adjusted to ensure profitability. Due to the growth of competition in this stage, MFIs need to introduce new products and services which are more flexible and demand oriented, and may start focusing on different target groups. Moreover, they formalize organizational policies, procedure, regulation, and systems into the accepted industrial norms of the country's central bank so that they can integrate into the mainstream financial system.

4^{th}**, Integration phase**: MFIs have established appropriate legal and regulatory frameworks to transform into regulated financial institutions. Resources are mobilized during this stage through appeals for public and private investors, lenders, and depositors to support growth in the form of loans, equity and deposits from the public. More advanced MFIs may issue bonds or stock where a local capital market exists.

The evolution of microfinance industry from its beginnings up to recent times can be handily summarized by the following (see Figure: 2.6 and Figure 2.7) :

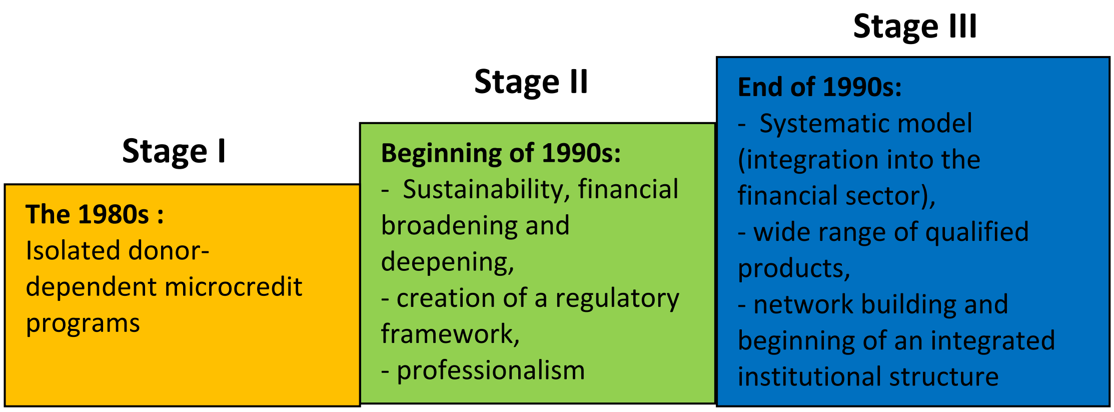
Figure 2.6: The Evolution of Microfinance Industry

Before	Now
Microcredit: -Group lending -Microenterprises	Microcredit: -Group and individual -Microenterprise, consumption, housing Microsavings Pension funds Microinsurance Payment services (remittances, transfer..)
Small scale	Large scale
Target group : the poorest and poor	Target group: wide (including SME, middle class...)
Service providers: ROSCAs+Village banks, Credit and saving cooperatives, NGOs	Service providers: ROSCAs+Village banks, Credit and saving cooperatives, NGOs, Up-scaled NGOs (4th sector), Non Bank Financial Institution (NBFI), Commercial bank
Status: Non-formal institution (self-owned, NGOs)	Status: Non-formal institutions (self-owned, NGOs) Non-bank financial institutions (regulated), Bank
Hardly operationally sustainable	Search for sustainability Many financial sustainable, some very profitable
Social impact taken for granted	Social impact to be proven
Funding: grants	Funding: grants, reserves, savings, investment, capital markets…..

Source : Jorge Berezo, presentation on ¨Commericial investment in microfinance¨, Oikocredit, Feb, 2011

(*Source : Jorge Berezo, presentation on "Commercial investment in microfinance", Oikocredit, Feb, 2011*)

Figure 2.7: The Evolution of Microfinance Industry



(*Source: Patrick Goodman "Microfinance Investment Funds: Objectives, Players, Potential", 2006*)

Although the microfinance industry has been steadily developing improving, the majority of MFIs in most countries are unable to become dynamic, efficient, multi-service institutions. The industry remains populated by a large number of small MFIs, with only relatively few large institutions. For example Bangladesh boats over 1,000 MFIs, however the four largest institutions including Grameen Bank, BRAC, ASA, and Proshika, account for over 70% of the total client outreach (Fernando, 2007b). Meanwhile, the growth in demand and in the number of institutions worldwide leaves the industry facing a shortage of funding for upscaling, innovating and maintaining sustainability of operations. Most MFIs still depend on donor grants or concessionary funds, which are becoming inadequate, and thus a majority of MFIs face the challenge of seeking a wider range of funding sources, such as equity financing or commercial debt, to supplement their funding requirements. As more and more MFIs generate positive returns, a new waves of investment flow into the sector. A recent phenomenon in the industry is the emergence of microfinance investment funds, who provide funding to overcome the current funding problem. (We will discuss more in chapter: 3).

2.3.5 Financial Needs of Microfinance's Clients

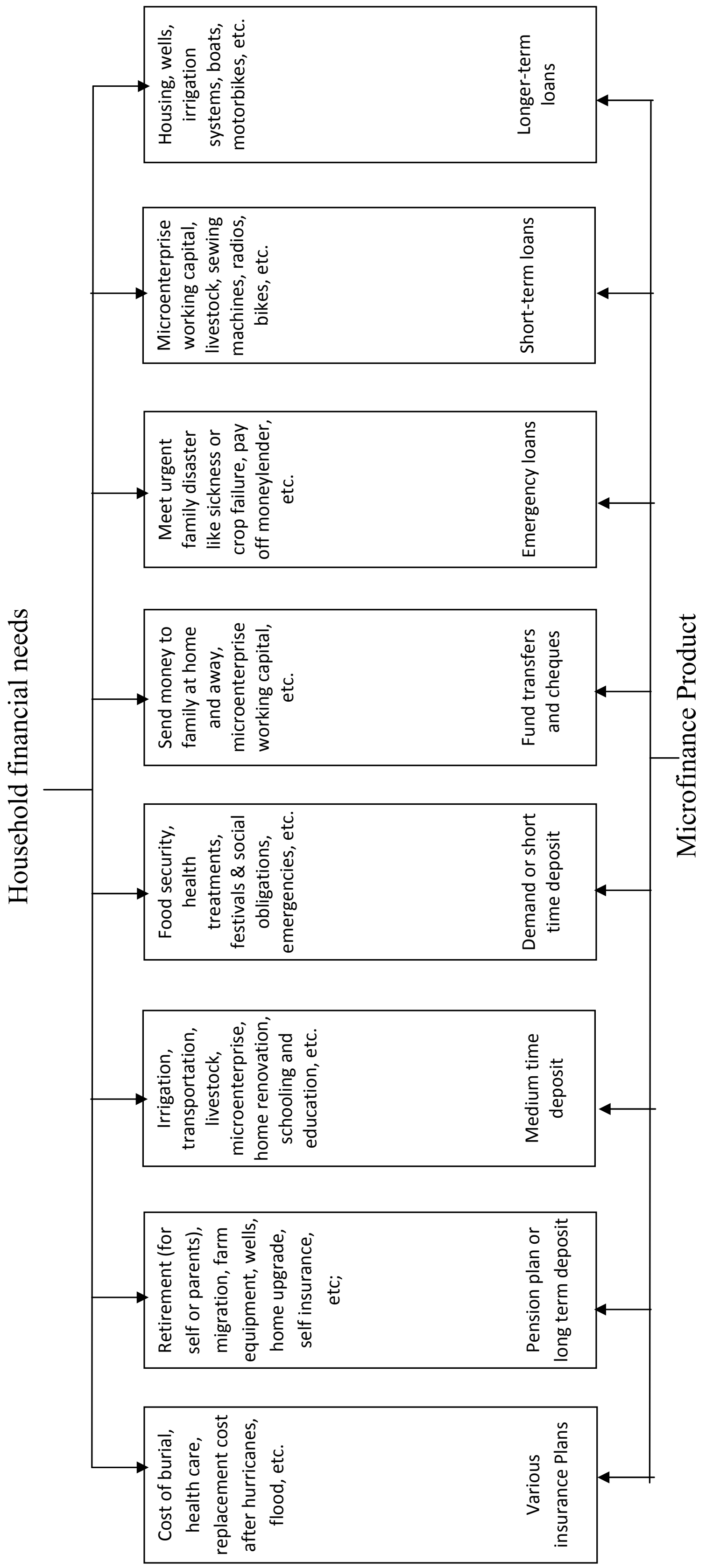
It appears that the main factor contributing to growth in the microfinance industry is increasing demand from microfinance clients. Why is this demand increasing? What are the services being used for? Rutherford (2001) identifies several purposes:

- Life cycle needs, such as weddings, funerals, childbirth, education, home building, widowhood, old age.
- Personal emergencies, such as sickness, injury, unemployment, theft, harassment or death.

- Disasters, such as fires, floods, cyclones and man-made events like war or bulldozing of dwellings.
- Investment opportunities, such as expanding a business, buying land or equipment, improving housing, securing a job (which often requires paying a large bribe), etc.

In greater detail, the uses to which short-term and long-term loans, deposit (saving), microinsurance, and remittance services are put as described in Figure: 2.8. A large proportion of the clients of Grameen Bank use services to support income generating activities. Females represent 75% of clients using loans for livestock and poultry raising, or processing and manufacturing activities. In contrast, about 50% of loans taken by males were for the purpose of trading and shopkeeping. Only a small portion of loans (6%) were for consumption or other household needs(Tiwari & Fahad, 1997).

Figure 2.8: An Example of Type of Microfinance Products Used by Poor



Source : Brett Matthews, Mathwood Consulting Company

2.4 Microfinance Products and Services

MFIs provide similar products and services to their customers as formal sector financial institutions. The scale and method of delivery of each MFI are different, but the fundamental services of savings, loans, and insurance are the same. MFIs have become more efficient and have increased their clienteles, so that they have begun to expand their services through different product offerings such as micro-savings, flexible loan repayment, micro-insurance, and money transfer and payment. These products and services are discussed below.

2.4.1 Who are the Target Groups of MFIs?

Target groups are selected in reference to particular financial and social goals. Generally, microfinance clients are poor or low-income people that have a relatively stable source of income but no ability to access formal financial institutions, such as commercial banks. Typically, microfinance clients are self-employed, often household-based entrepreneurs; about two thirds are women, and both rural and urban areas are covered (Novak, 2011). Target groups in rural areas are usually small-scale farmers and persons who engage in small income-generating activities such as food processing and petty trade. Microfinance clients in urban areas are more varied in their activities, and include shopkeepers, service providers, artisans, street vendors, etc.

Initially, the provision of microcredit is mainly targeted to the "poor" and "non-bankable", who do not meet the requirements to qualify for traditional bank loans. Putzeys (2002) defines poor people can be distinguished in two categories. "Entrepreneurial poor" are those who are able to improve their income by establishing income generating activities, such as a street vendor; "non-entrepreneurial poor" are those who have no capacity to start income generating activities because of a lack of personal skills or position and who need the direct assistance of a social network to survive. Microfinance, therefore, targets to the entrepreneurial poor.

MFIs have been expanding their target market to include low-income people and the poorest of the poor (ADB, 2000). Recently, microfinance programs have expanded geographically to find borrowers who have the potential to generate income, and are able to repay loans. A microloan is typically provided to any low-income self-employed borrowers, or tiny informal business owners, rather than salaried workers. The Grameen Bank, for example, makes small loans in rural areas through a large network of branches and alternative delivery services. In addition, microfinance has presently shifted to vulnerable non-poor groups, another important target group, given that this group includes people who could become more vulnerable and easily fall into poverty if they are unable to obtain financial services. These non-poor groups can create employment opportunities for the poor through their small enterprises. Loans for the non-poor help MFIs achieve a higher level of efficiency, better financial sustainability in the short-term, and broaden their potential market.

Women are a popular target group for microfinance programs. In fact, the Microcredit Summit Campaign launched a nine-year campaign (1997 to 2005) to reach 100 million of the world's poorest families, particularly the women of these families, with credit for self-employment and other business services (Daley-Harris, 2002). There are several reasons why this approach was taken: loans to women generally have a higher repayment rate compared to men, as women generally show a greater spirit of enterprise. Female borrowers usually treat their businesses very seriously, and make an essential contribution to the economy of developing countries. In addition, women often do not have any assets to use as collateral for a loan, since assets or land are usually registered on the name of the husband, restricting access to credit. Moreover, in a family, income generated by the mother generally has a bigger impact on the well-being of the entire family, as it is used for improved nutrition, education, or health care. This access to credit not only improves women's financial opportunities, but also their social-cultural status (positions in the family and society), psychological well-being (increased self-esteem) and political impact (more decision making power). Hence microfinance is a powerful tool for improving the status of women.

2.4.2 Microcredit

Microcredit provides small borrowing of funds over a specified term for repayment, depending upon the borrower's situation. Assuming capacity to access the loan for a business exists, it makes sense to borrow funds to continue the business activity when accumulated savings or capital to finance are insufficient, and the cost of funds does not exceed the return on funds borrowed (Waterfield & Duval, 1996).

Microcredit is the microfinance industry's core service. Grameen Bank[16], 2009 defines microcredit as "small loans to very poor people for income generating activities, allowing them to care themselves and their families". Typically those tiny loans are repaid within short periods of time and are generally made to micro-entrepreneurs for productive purposes to generate revenue. John Hatch, the founder and chairman of ACCION International (as cited in Woller et al., 1999), stated that microcredit is designed to allow the poor to "participate in the free market system". Many MFIs insist that only productive loans are offered[17], while some also provide credit for consumption smoothing, like housing, emergencies, health, education, special occasions or life-cycle events.

[16]Grameen Bank, Microcredit Definition, http://www.grameen-info.org

[17]According to (Ledgerwood, 1999), this refers to any loans that increase the liquidity of the household by freeing up enterprise revenue, which can be reinvested

In principle, the size of a loan is based on the financial capacity of the borrowers to pay back the credit. The loan size is generally small and is enlargeable, on average from US$3,000 in Europe and Central Asia, and less than US$1,000 in other regions (Reille et al., 2010). A popular and successful philosophy in credit schemes is to start with a small amount of credit for a first loan cycle in order to check the creditworthiness of the borrower, and to provide an opportunity for the borrowers to conduct a business with the small investment amount. Subsequent loan amounts can be bigger once borrowers have learned how to manage their investments and proven their reliability and creditworthiness. The loan period depends mainly on the type of investment and the capacity to pay.

As mentioned, the target market for micro-credit are the poor and non-bankable people who are unable to obtain loans from financial institutions because of *collateral* requirements. Most of MFIs currently focus on securing social collateral via group lending (see section: 2.4.2) where borrowers cannot meet physical collateral requirements[18]. The guarantee between group members to repay an MFI loan in the event of a member default functions as a collateral substitute, and is known as social collateral. Social collateral has an impact on the reputation of group members, where the regular repayment of loans by each members is necessary to maintain social standing in the community (Woller et al., 1999).

Method of credit delivery: Microcredit distribution methods can be categorized into two broad approaches, based on the ways an MFI distributes and guarantees its loans: individual and group lending (Brau & Woller, 2004).

[18]In financial terms, collateral refers to any valuable properties, such as jewelry, house, land, share in enterprises, etc. that a borrower pawns to the lender in order to get credit, which defaults to the lender when the loan cannot be repaid.

1. Individual Lending Approach

Households and small entrepreneurs can obtain individual credit from MFIs depending upon their ability to secure the repayment. MFIs have formulated effective individual lending models which follow the models used by both formal and informal institutions. The individual lending model is characterized as following (Waterfield & Duval, 1996, as cited in Ledgerwood, 1999):

- The potential clients can be identifying by checking credit history and character references.
- The loan guarantee can be in some form of physical collateral (MFIs define this less rigidly than formal lenders) or through a co-signatory (a third person, who has not taken a loan from the MFI, and who legally agrees to repay the loan in case of default).
- The adapting of loan size and term to adapt for business needs.
- The frequent increase of loan sizes and terms over time.
- The effort of MFI staff to develop close relationships with clients so that each client represents a significant investment of staff time and energy.
- The requirement of frequent and close contact with individual clients to keep track of clients' situations.

In some countries, individual lending exhibits higher average loan amounts and often primarily serves the self-employed, rather than the very poor seeking to start a business. The loan sizes to individuals are commonly greater than loans to members in a group, compared to the group lending approach. Accordingly, individual loans generate a larger *revenue base* to cover the delivery and maintaining of costs than in the case of group loans, at a given equal number of loans.[19] In addition, the models of individual lending may be less expensive and less labor-intensive than the formation of a group-based model. Individual lending is most successfully provided in urban areas where credit is accessible. It can succeed in rural areas, mainly through savings and credit cooperates or credit unions. In both urban and rural areas, individual lending is often offered to those borrowers who are better off than the very poor, and those who borrow for productivity purposes (Ledgerwood, 1999).

2. Group Lending Approach

Microcredit programs typically provide credit to households who have few assets that can be used as collateral or who are extremely poor and have no collateral at all. To ensure the terms of repayment from a borrower who has no collateral, most microfinance institutions usually apply the "group lending" approach as an alternative guarantee. Globally, 63% of total MFIs apply this group lending approach, representing 65% of all micro-borrowers; the remainder is individual loan only (Novak, 2011). The group lending approach generally provides either loans to individuals who are members of a group, with each member guaranteeing each other's loans, or to a group that then sub-loans to their members. This approach is often based on or mimics the existing informal lending and savings groups (Ledgerwood, 1999). There are a variety of methodologies in the group lending approach, but all are based on the principle of joint liability.

Joint liability group is the best known lending technique innovation arising from microcredit programs, in which members accept joint liability for the individual loans made. Under joint liability, each group member is made responsible for

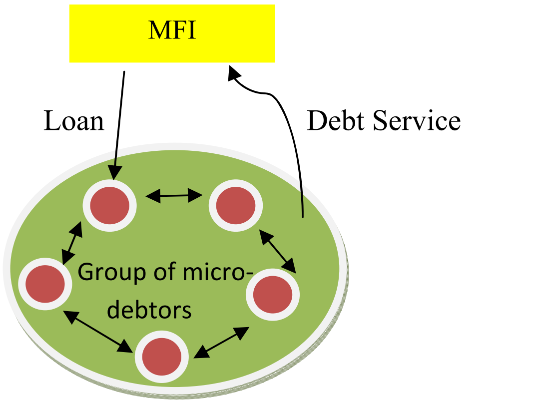
[19] The earning of interest revenue on outstanding amounts of a loan portfolio is the base revenue. The larger the amount lent, the greater the revenue, and hence the more available funds exceed the cost because interest revenue is based on a percentage of the amount lent.

the loan of other group members. If a member defaults (fails to repay), the other group members are obliged to cover the amount of loan default from their own resources, or lose access to future credits in the next cycle. This joint responsibility approach results in low levels of default, but there are other methods of encouraging successful repayment rates, such as dynamic incentives, regular repayment schedules and collateral substitutes. In addition, some MFIs have employed a group lending approach that adapts the RSCA model to provide additional flexibility in loan sizes and terms, and generally allowing borrowers to access funds when they are needed, rather than having to wait for their turn.

The Formation of the Group: The nature of group borrowers differs between schemes. In many cases, prospective members are asked to form groups by themselves, composed of people who have a common wish to access credit, particularly from the same commune, friends, or people from the same peer group. Tassel (1999) concludes that agents will always establish groups with agents of the same type, and that agents' types can be distinguished according to the rate at which they are willing to increase joint liability commitments for lower interest rates.

Group members meet regularly, weekly or monthly in most schemes, where screening and deciding on the agreeability of proposed loans to new borrowers takes place. MFIs do not individually collect loan repayments from each member, but from the group. If a member defaults, the group needs to take charge of repayments to the MFIs by sharing the debt among the group members. The group can access new loans should good repayment rates be achieved. MFIs often apply incentives to each group loan in order to promote repayment rates, as well as in-time repayment installments of all group members. The probabilities of repayment rate increase flow from their own selection of trustworthy individuals (Putzeys, 2002). In most cases, the function of group leader rotates yearly.

Figure 2.9: An Example of Group Lending Approach



Source : Deutsche Bank Research 2007

(*Source: Deutsche Bank Research 2007*)

Advantage of group lending: According to De Aghion et al. (2005), group loans are more likely to be repaid than individual loans. Borrowers can use peer pressure to assure loan repayment by group members and as substitute collateral (De Aghion et al., 2005). Default by one member usually means that further lending to other members of the group is terminated until the amount of loan outstanding is repaid by the group. Grouping by financial and social type has drawn out several dynamic scenarios that may increase repayment rates and reduce transaction costs. For example, peer pressure from other group members can act as a repayment incentive, since members do not want to let down the other members of their group, or suffer any social sanctions imposed by the group as a result of defaulting. It may also reduce certain institutional transaction costs by lowering screening and monitoring costs, and an MFI can extend outreach even in the face of asymmetric information through the self-selection of group members.

Group lending provides a guarantee for repayment, and also reduces administrative costs. This approach benefits group members in several ways: as the position of group leader rotates every year, different members learn how to take on the responsibilities of leadership, an opportunity they would never have when lending at a formal bank. The position of group leader also gives them the capacity to participate in the community and to increase their self-esteem by taking an active part in the social activities. Solidarity groups encourage people to be more involved and responsible, and form a channel for the exchange of information, assistance and advice. Mutual assistance between group members is an easy and cheap method for the dissemination of knowledge and information. In addition, Ghatak (1999) concludes that group lending not only increases repayment rates and welfare via social collateral, but also due to peer selection by members of the lending group. Similarly, Islam (1996) cites that lenders using peer-monitoring systems can charge lower rates relative to conventional lenders, and the expected rate of repayment is higher, with lower risk, at the same interest rate.

Take for example Grameen Bank (GB), established in 1976. The GB lending system is simple but effective. To obtain loans, potential borrowers must form a group of five and present themselves to the bank, and gather once a week for loan repayment meetings. Individual groups in the same village are federated into a central group. The organization of members into groups and centers serves a number of purposes, including providing individuals with a measure of personal security and the confidence to take risks and launch new initiatives. The formation of the groups is the key unit in the credit program, and is the first necessary step to receive credit. After agreeing to the bank rules, loans are firstly lent to two individuals in the group, who are then under pressure from the rest of the members to repay in good time. If the first two successfully repay their loans, then four to six weeks later the next two are offered a loan; after another four to six weeks, the last person is offered a loan. As long as all members in the group repay their loans, the promise of future credit is extended, but if the borrowers default, the other members of the group may forfeit their chance of a loan (Tiwari & Fahad, 1997).

Hence the groups perform as an institution to ensure mutual accountability. The individual borrowing member is kept in line by considerable pressure from other group members. The credibility of the entire group, and future benefits in terms of new loans, are in jeopardy if any one of the group members defaults on repayment. The initial loan is small, generally less than $100, and repayment are at a rate of 10 percent per year[20]. The collection of weekly installments during a public meeting ensures transparency, as any borrower who defaults is visible to the entire village, which imposes a sense of shame. There have been occasions when a group has decided to fine or expel a member who has failed to attend weekly meetings or willfully defaulted on repayment. Members are free to leave the group before the loan is fully repaid; however, the responsibility to pay the balance falls on the remaining group members. In the event of default by the entire group, the responsibility for repayment falls on the center. The Grameen Bank has provided an inbuilt incentive for prompt and timely repayment by the borrower, i.e. the gradual increase in the borrowing eligibility of subsequent loans. Factors behind success of the Grameen Bank are: a participatory process in every aspect of the lending mechanism, peer pressure of group members on each other, lending for activities which generate regular income, weekly collection of loans in small amounts, intense interaction with borrowers through weekly meetings, strong central management, dedicated field staff, extensive staff training willingness to innovate, committed pragmatic leadership, and a decentralized as well as participatory style of working.

Grameen Bank II also provides a good example of change to more flexible loan repayment. Group lending still exists and is an integral part of the process,

[20] See Grameen Bank information on www.grameen-info.org:bank/GBGlance.htm

but Grameen II introduced a flexi-loan that allows borrowers multiple options to repay their loan on an individual basis. The flexi-loan is based on the assumption that *the poor will always pay back a loan, and this allows the poor to reschedule their loan during difficult periods without defaulting*. If the borrower repays as promised, then the flexi-loan operates exactly like the basic loan, using dynamic incentives to increase the size of the loan after each period. If the borrower cannot make her payments, she is allowed to renegotiate her loan contract rather than default. She can either extend the life of the loan or repay only the principle for an extended period of time. As a penalty, the dynamic incentives of her loan are reset; she cannot access larger (additional) amounts of credit until the original loan is repaid. Because her default now poses no threat to the group promise of future credit, each member is accountable only up to their individual liabilities.

Not all MFIs apply the group lending approach, and some MFIs prefer to lend to individuals without any sharing of liability. While the advantages of both approaches have already been discussed, it can be argued group lending has some failings and constraints, for example that this approach only fully works in rural area where social control is higher. In addition, there is a potential for bias, since an individual is accepted as a group member based on their own merits, which is an obstacle to for the extreme poor, those who are not in the peer group to begin with. Both approaches have their advantages and respond to different circumstances; it can be safely assumed that both individual and group lending techniques will continue to coexist over the long term.

2.4.3 Microsaving

In principle, along with credit (lending) service, a market exists for savings in poor areas around the world. Microsaving programs provide poor people with the possibility of saving even very small amounts, and to help them to accumulate a lump sum in formal or semi-formal institutions to pay for their children's education, for major life events (such as funerals or marriages), for recovering from natural disasters, or for establishing a small business. Through this mechanism, people may learn the principles of savings and money management, and acquire the habit of saving. To encourage and promote saving, MFIs apply techniques in a flexible manner, either deposit taking directly or making arrangements with other financial institutions to provide saving facilities (Barry, 1995).

Most, MFIs apply microsaving programs by linking to microcredit schemes. Putzeys (2002) suggests that a savings mechanism should be developed and employed once an entity introduces a credit model, in order to protect undesirable risks for external funds. With the extra funds produced by savings, new borrowers can be attracted to participate in the credit program, enabling them to generate capital by depositing savings, even though the interest rates are usually less than those to be paid for commercial lending. The greater the involvement of people in the community in savings the higher the motivation of borrowers to pay back loans which are partly financed by the savings. As a consequence, higher repayment rates can be expected. It is important that saving schemes are reliable and easily accessible. Regulations and conditions (e.g. interest rates) should be clearly defined.

Many MFIs have a mandatory or suggested savings rate, and for larger loans, MFIs will often require borrowers to deposit into a saving account, for example, 5 percent of the loan. Some, but not all, have restrictions on when and how that money can be accessed. Savings mobilization also makes financial institutions accountable to local shareholders. Thus sufficient savings facilities both satisfy the demand of customers for financial services, and fulfill the essential requirement of lenders in terms of financial sustainability. However, not all MFIs seek savings mobilization, because the related costs on small amounts of savings is expensive, and administration is complicated. Moreover, the volatility of loan portfolios may place deposits at high risk if the MFIs fund unsafe lending operations (Tariku, 2003).

Prudential financial regulations are necessary when MFIs start mobilizing household savings, as they must secure the depositors to ensure solvency and financial soundness. At the same time, excessive regulations may restrain their viability (Vetrivel & Kumarmangalam, 2010). Savings services offered by MFIs can be divided into compulsory and voluntary savings.

1. Compulsory Savings

Many MFIs use compulsory saving programs, which restrict a borrower's access to deposited funds, and from which the MFI can withdraw money from if the borrower cannot make payment in some periods (Nørgaard Jørgensen, 2012). These savings can be called "compensating balances", compulsory funds that the MFI requires as a contribution from borrowers, at a minimum amount each week (or other set period of time) as a part of their participation in credit access, as a condition of receiving a loan. Sometimes the amount is a percentage of the loan, sometimes a nominal amount. Generally, compulsory savings are so closely tied to receiving and repaying loans that they are recognized as part of a loan product, rather than being a discrete savings product. They promote long-term savings, but ignore the fact that many poor save for the short term to smooth consumption costs during seasonal lows of production. In practice, compulsory saving is considered as cash collateral, since the funds cannot be withdrawn by members while they have a loan outstanding, so they cannot use their savings until their loan is repaid. In some cases compulsory savings cannot be withdrawn until the borrower actually withdraws his or her membership from the MFI. This sometimes results in clients borrowing loan amounts that are in fact less than their accumulated savings. For the borrower, compulsory savings represent an asset while the loan represents a liability; thus the borrower may not view compulsory saving as part of the loan product.

As MFIs have become better versed in the microfinance market, they have applied their innovations in lending to the collection of deposits. One of the leading examples is SafeSave, located in Dhaka, Bangladesh, which uses the idea that frequent small deposits will guard against the temptation of spending excess income. Another example is Grameen Bank, that requires every member to save*one Taka* per week, which is accumulated in the Group Fund (Tiwari & Fahad, 1997). This account is managed by the group on a consensual basis, thus providing the members with an essential experience in the collective management of finances. Amounts collected from penalties imposed on members for breach of discipline are also put into this account. The monies in the Fund are deposited with Grameen Bank and earn interest. A member can borrow from this fund for consumption, sickness, social ceremony or even for investment (if allowed by all group members). Terms and conditions of such loans, which are normally granted interest free, are decided by the group.

Compulsory savings also acts as insurance for MFIs in case of default. If a member is expelled for default, her group fund is adjusted by the amount of the loan outstanding. Private lenders who lend to groups, such as Grameen Bank, have been able to internalize this by requiring that groups create savings pools that function as an insurance fund for the members. The original Grameen Bank was one of the first MFIs that incorporated a compulsory savings requirement into their lending structure. Every client was required to make a deposit worth 5 percent of their given loan, which was placed into a group fund with strict withdrawal rules (generally no withdrawals before three years). In 2001, the Grameen Bank reviewed both its lending and savings policy and reinvented itself as Grameen II. At the heart of this change were more savings options and more flexible loans, which act as a form of insurance. New to Grameen II is a pension fund, which allows clients with loans greater than 8,000 Taka (US$138) to contribute at least 50 Taka (US$0.86) per month. The client receives 12 percent per year in compound interest, earning a 187 percent return after the mandatory 10 year wait. This scheme allows Grameen II to earn more money in the present and expand services, while delaying payment to the near future (Sengupta & Aubuchon, 2008).

2. Voluntary Savings

As the name suggests, voluntary savings is not an obligatory part of accessing credit services. Both non-borrowers and borrowers of a microfinance institution are able to access such services, and they can deposit or withdraw according to their needs (Ledgerwood, 1999). Interest rates range from relatively low to slightly higher than those offered by formal financial institutions. In addition, MFIs that offer voluntary saving services must have greater liquidity to meet the unexpected increase in saving withdrawals. A reasonable estimate of the market for savings among the poor indicates that savings demand substantially exceeds the demand for enterprise loans. Christen, 2001 (R. P. Christen, 2001), for example, reports that over a space of two to three years, retail banks in Latin America opened millions of small deposit accounts in countries while MFIs added fewer than 200,000 loan customers over the same period. For MFIs that offer both enterprise loans and voluntary savings, savers typically exceed borrowers by large multiples.

2.4.4 Micro Insurance

Definitions of micro-insurance differ depending upon product characteristics, price, methods and target groups. Churchill & Frankiewicz (2006) defines microinsurance as a tool to prevent low-revenue people from specific dangers. The insurance policy holder makes regular monetary payments (premiums) proportionate to the likelihood and cost of the risk disclosed. As with all insurance, risk pooling under microinsurance attempts to allow many individuals or groups to pool risks and redistribute the costs of the risky events within the pool.

A characteristic of poor households is extreme vulnerability to risk and external shocks. Traditionally, poor households have managed risk and coped with external shocks through a combination of informal social support networks, savings, and borrowing from informal moneylenders. Among the poor, there is a demand not only formal savings and credit but also a considerable demand for formal insurance (Churchill, 2002). Few poor households have access to formal insurance to protects against risks such as the death of a family breadwinner, severe or chronic illness, or loss of an asset, including livestock and housing. These shocks are particularly damaging for poor households, as they are more vulnerable and less able to absorb the financial consequences of such an event. The greatest challenge for microinsurance schemes is providing real value for poor households: finding the right balance between adequate protection and affordability.

Although microinsurance products are becoming increasingly available, microinsurance is a new field and still in the experimental stage. Most mature MFIs launch microinsurance services in their target population. The most basic insurance is debt relief for the death of a borrower, offered by many MFIs, including Grameen. Other MFIs have begun experimenting with *health* *insurance* and *natural disaster insurance*. As with lending, agency problems present a dilemma for microinsurance. To this end, some groups such as FINCA Uganda require life insurance of all borrowers, including "risky" and "healthy" alike, and thus seek to avoid the adverse selection problem. Other ideas include providing rain insurance to guard against catastrophes. This relies on the assumption that crop yields (and much of the developing economy) are tied to seasonal rain cycles. This innovation eliminates the problem of moral hazard associated with a crop loan. By tying performance to rain cycles, a farmer has no incentive to take crop insurance and then fail to adequately produce a crop during a season of adequate rainfall.

At Grameen Bank, for example, each member is required to contribute 1 percent of their loan amount to an insurance fund. In case of the death of a client, this fund is used to repay the loan and provide the deceased client's family with the means to cover burial costs[21]. Although microinsurance is in the early stages of development, efforts are being made to formalize and design the process. There are some success stories (e.g., FINCA Uganda offers its clients health and other types of insurance through an AIG subsidiary based in South Africa), but overall progress is modest so far, owing in part to the very different nature of insurance compared to savings or loans, and the fact that few MFIs possess specialized knowledge of how to set up analyzes crop insurance in Gujarat and finds that the availability of crop insurance resulted in increased loan repayments in absolute terms, although it is not clear if the propensity to repay improved. Additionally, Mishra documents a significant increase in the flow of credit to insured farmers after the introduction of the insurance program[22].

[21] Joanna Ledgerwood ï¿½Microfinance Handbook: An institutional and financial perspectiveï¿½, 1999

[22] James C. Brau and Gary M. Woller "Microfinance: A Comprehensive Review of the Existing Literature", 2002

MFIs are expanding beyond credit to a broader array of financial products, with increasing interest in offering their clients access to microinsurance products. Some MFIs cooperate with insurance companies; while commercial insurers provide the majority of the world's products, mutual, cooperative and other community-based or community-led insurance organizations are emerging as providers of microinsurance.

2.4.5 Payment Services

Some microfinance institutions extend existing services to provide payment services to poor and low-income households. These services include the money transfer for seasonal workers or migrants who are working in urban areas and wish to send money back home to family and friends in rural areas, and also bill payment and payment of goods purchases for a business, the transfer of government employee salary and benefits. The service charges are quite high since the amounts remitted are often small. However, with the improvement of delivery channel technologies, from traditional use face to face to ATMs, mobile branches, etc., and the increase of competition in this sector, the fees are expected to be reduced (Ledgerwood, 2012).

The First Microfinance Bank in Pakistan began to provide domestic money transfer services a few years ago, and has been able to expand this operation substantially in recent years. ACLEDA Bank in Cambodia has dramatically increased the number and volume of domestic money transfers. In 2001, domestic money transferred amounted to US$7.0 million in 886 transactions; in 2005, the amount increased to US$286.7 million in 98,171 transactions. Adhikar, a small NGO-MFI based in the Indian state of Orissa, provides money transfer services to migrant workers in competition with post offices (Fernando, 2007b).

2.5 Microcredit Interest Rate

The primary topic to be studied in best practice for MFIs is the setting optimal interest rate for target groups, whether lending to the poorest, the poor, the less poor or the non-poor. The mechanism is far different from the setting of interest rates in for-profit financial institutions, where it is determined by what rate level will maximize a shareholder's wealth. In contrast, MFIs face unique issues in setting appropriate rates to target clients. For microcredit interest rates, the goal is to offer clients affordable, viable and long-term financial services on a large scale (CGAP, 2003). The setting of interest rates varies significantly depending on the type of service providers. However, this original objective is subject to modification with the increasing investment of private investors, where there is a tendency to generate higher profits to sustain lending operations, and to provide a competitive financial return to their shareholders. Very high interest rates often must be charged to borrowers.

Microcredit is seen as a development tool to lift the poor in developing countries out of poverty. However, microloan interest rates for poor borrowers are considerably higher than richer borrowers pay to banks. Because microfinance institutions generally incur huge costs, higher rates are charged. The costs that determine interest rates include the cost of funds, operating expenses, loan loss expenses, and profit needed to expand the capital base and fund expected future growth (Fernando, 2006). Similarly, Putzeys (2002) states that to be sustainable, MFIs must set interest rates that cover all operation costs, plus the cost of capital (including inflation), loan losses, and a provision for increasing equity. The model presented below is simplified and imprecise, however it is useful for many MFIs, especially for the newer entities, to estimate the interest rates that they need to realizing their loans.

$$\text{Interest Rate} = \frac{\text{Operating cost+Financing cost+Loan loss+Capitalization}}{1 - \text{loan loss}}$$

(Each of the above factors is presented as a percentage rate, calculated per average outstanding loan balance)

Unsustainable MFIs (microfinance NGOs) charge lower interest rates than sustainable MFIs because they intend to address the needs of poor borrowers, so their rates are not constrained by costs, and losses are covered by donor or government subsidies. Advanced MFIs charge higher microcredit interest rates due to related costs. First, the expensive cost of borrowing, which was averaged at 5.1 percent in 2006. MFIs are less able to leverage than commercial banks - fewer portfolios, and other assets, are funded by the liabilities on which they have to pay interest (Lützenkirchen et al., 2012). In addition, higher inflation and devaluation in currency exchange also have to be taken into account when assessing the cost of funds (Fernando, 2006). The rate of loan default and delinquency in MFIs, even it is quite low compared to commercial banks in developing countries, also has relatively little effect on interest rates. To be an efficient scheme, the rate of loan loss provision should be around 1% to 2%.

Furthermore, the capitalization rate represents the real net profit that MFIs require where they intend to retain operational profits as a way to increase equity and promote financial sustainability. A capitalization rate should be within the range of from 5% to 15% of average outstanding loans, depending upon the decision of the management board (Putzeys, 2002). Lastly, some studies show that the main reason why microcredit interest rates are higher than those of other financial institutions is the higher operational costs, such as administrative and personnel expenses, that are necessary to deliver small loans, wich contribute about 60 percent of total MFI costs. "Lending US$100,000 in

1,000 loans of US$100 each costs most than than a single loan of US$100,000" due to costs of transportation, regular collection, staff salaries, etc. Among the broad range of factors that have an impact on operating costs are the age, scale, and density of clients, the rural/urban divide, stability of clients, the type of loans provided (e.g., individual versus group lending), and issues of late repayment.

Consequently, microfinance institutions need to charge much higher interest rates, ranging from 15% to 70% (Dieckmann, 2007), which differ markedly according to geographic region. For example, in Thailand, thanks to government subsidization on funds lent to the poor allow MFIs to charge interest rates are considerably lower than neighboring countries. Rates in Thailand usually range from 10 to 20%per year, while Cambodia and Vietnam have interest rates around 30 to 50% per year. [23]

The issue of high interest rates may seem an abusive of the poor borrowers who have limited options, and consequently the perception of a drift away from the social development objective, helping the poor out of poverty instead forcing them more indebted. Excessive interest rates may also lead to MFI losses as borrowers cannot pay, default on loans, and, in the case of group lending, damage down their solidarity groups. At the same time, micro borrowers can often afford such high interest rates by favorably comparing microcredit costs to their overall business or household costs, income streams, and informal financial alternatives. The poor usually consider access to credit more important than actual interest cost (CGAP, 2002b). Consequently microcredit interest rates are still one of the industry's most discussed issues, causing the deepest concern, and capturing the attention of governments, media and microcredit practitioners.

[23] http://www.microfinancethailand.com/faq.htmnum3

Comparison of microcredit interest rate with other micro-loan rates Based on a study of 21 countries, informal credit (informal money lender, pawnshop), median of informal rate reported was 10 to 25% per month, higher than microcredit rates. Poor borrowers who have less bargaining power and are unable to obtain loans from MFIs need to use informal credit since it is quickly attainable and is a simpler process (Dieckmann, 2007). In some emerging countries, moneylenders commonly charge effective interest rates in excess of 10% per month. For example, a standard moneylender loan in the Philippines is "5/6 loan" - for every five pesos borrowed in morning, must be repaid by 6 in the evening, which equates to a daily interest rate of 20% (CGAP, 2002b); compare that to credit unions, where the average interest rate charged by MFIs in the 10 countries studied, was usually higher than (Dieckmann, 2007).

Basic type of microcredit interest rate: Microcredit service providers generally collect loan payments in periodic installments, in which the interest is paid along with principal, weekly, bi-weekly or monthly. They charge interest rates through two ways of calculation. Firstly, *declining interest rate*, where the microcredit provider considers the loan balance of each borrower as the base for calculating the monthly interest rate. The interest paid will decline when monies outstanding reduce during the loan cycle. Secondly, *flat interest rate*, the amount of the monthly interest to be paid is fixed base on principal of loan lending to each individual, not taking into account what the outstanding balance of the loan is. This system makes it easier to calculate a repayment schedule and is easier to understand for the borrower. But in fact, the borrower pays more interest than quoted in the nominal interest rate. In practice, the interest rate charged by MFIs is one of the main sources of revenue, and has to be high enough to cover all costs.

Therefore, to be successful, MFIs should have the capacity to find innovative ways to improve their productivity and efficiency, principally to reduce relevant costs in order to ensure an affordable and viable interest rate for their clients. Cost reductions can be achieved through simplified and decentralized loan application, approval and collection processes, for instance, through group loans which give borrowers responsibilities for much of the loan application process, allow the loan officers to handle many more clients and hence reduce costs (Otero & Rhyne, 1998). For example, to keep transaction costs of daily deposits low, SafeSave hires poor workers from within the collection areas (typically urban slums) to meet with clients on a daily basis. By coming to the client, SafeSave makes it convenient for households to save; by hiring individuals from the given area, training costs and wages are also kept low. With this efficient model for both bank and individuals, SafeSave has accumulated over 7,000 clients in six years (Sengupta & Aubuchon, 2008).

Importantly, the development of technologies and the increase of competition for efficiency and effectiveness in the microfinance industry in the last two decades has resulted in a more competitive industry, and a benefit to their clients in terms of more flexible and higher quality micro financial services, particularly leading to lower microcredit interest rates. In Cambodia, for example, ACLEDA bank and AMRET have reduced their interest rates on microloans during the last four years several times. Rates have declined from 10% to about 3 to 4% per month (Fernando, 2006). ASA, in Bangladesh, reduced its flat interest rate from 15% to 12.5% per year in January 2007 (Fernando, 2007b).

In brief, this chapter outlines a theoretical comprehension of microfinance, before going on to understand the particular microfinance investment funds which closely relate to this research topic. With this chapter we come to the conclusion that the microfinance industry has experienced dramatic growth during the last two decades. Many microfinance NGOs have transformed themselves towards regulated financial institutions, involving themselves gradually in capital markets. Such growth has led many MFIs to diversify their services into microsaving, microinsurance, and payment and remittance into broader regions. Since microfinance is known as a useful tool to contribute to economic development, most countries require microfinance because the unserved and underserved target group remain large. However, pursuit of growth in terms of breadth, depth, and scope of outreach lead MFIs to seek for additional sources of funding to complement the existing sources and to be financially self-sustainable. The new funding opportunities include microloan portfolio securitization, and even some advanced MFIs have gone public. The increasing involvement of private sector investors acknowledge microfinance's dual nature - the promise of both social development and financial returns. The emergence of microfinance investment funds and the expanding opportunities for investors and MFIs will be discussed in chapter: 3.

Chapter 3

Literature Review: Microfinance Investment Funds

This chapter reviews the current state of knowledge about microfinance investment funds. It is important to know the way that microfinance funds work and how they contribute to the microfinance sector, what benefits and risks flow from investment in microfinance funds. A study of relevant literature is essential to develop clear and comprehensive research questions, and for determining what is known and unknown about the chosen research topic, and provides theoretical guidance for checking and comparing the results of data analysis. This chapter begins with the definition of microfinance investment funds and and their association with microfinance institutions (in section: 3.1 and 3.2). In section: 3.3 we examine the growth and challenges of microfinance funds in parallel with the growth of microfinance sector.

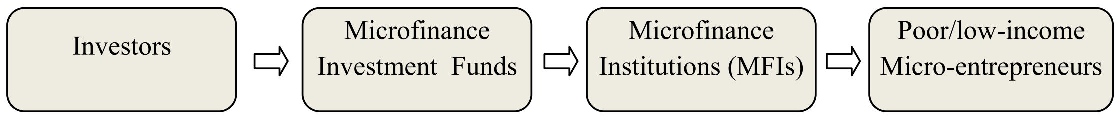
Next, this chapter introduces how microfinance funds are financed, what financing tools are being used in the microfinance sector, the main types of investor and their functions in microfinance (in section: 3.4, 3.5, and 3.6). The classification of microfinance funds is described in the section: 3.7. There is also a short introduction to what is called socially responsible investment in microfinance in section: 3.8. The dual return profile, the potential risks and benefits arising from investment in microfinance funds are demonstrated in section: 3.9 and 3.10. Towards identifying gaps in the literature, the section: 3.11 outlines what investment strategy is, its various components, and how investment selection is conducted in general context. At the end, the chapter summarizes what is currently represented in the literature and what is not, in relation to the research topic.

3.1 What is a Microfinance Investment Fund?

In simple terms, a microfinance investment fund is an investment entity that includes microfinance as one of their core investment objectives and mandates (CGAP, 2010b). Funds can be established by an institution with a particular aim to invest in microfinance assets (in some cases with trade finance investments) in which social or commercial, private or institutional investors can invest. By obtaining financing from investors who act as shareholders or as lenders, funds refinance equity and/or debt to microfinance institutions (Goodman, 2006), and thereby contribute to economic development, while providing adequate financial returns to their investors. Some funds may focus on a higher level of return, and some may be more socially oriented, emphasizing a reputational return with sufficient or marginal financial benefits. Funds that are created with charitable intent, making donations or providing finance to MFIs at subsidized rates, are not considered as investment vehicles (Köhn & Jainzik, 2005).

Microfinance funds are considered a convenient tool for investors to invest collectively in a wide and diversified range of MFIs, where funds act as a dynamic investment intermediary to make the microfinance industry more efficient, not only for investors who are active in capital markets but also for MFIs serving the marginalized group. Funds are varied in terms of size, legal form, capital structure, investment philosophy, and targeted return rates are determined by a variety of players. All, however, serve the same purpose: to channel increased funding to micro-entrepreneurs and the poor via microfinance service providers in developing countries and transition economies (see Figure: 3.1). Microfinance investment funds are increasingly seen as a core part of the funding of microfinance institutions.

Figure 3.1: Microfinance Investment Funds



For the purpose of this study, we have counted microfinance investment vehicles (MIVs) as microfinance investment funds. CGAP classified microfinance investment vehicles into six following major categories or peer group based on their business model, commercial orientation, financial instruments and asset classes (Reille, 2007):

- Registered mutual funds targeting primarily retail investors and seeking close to a money market return from primarily fixed-income investment
- Commercial fixed-income investment funds targeting public and private institutional investors and seeking market return
- Structured finance vehicles offering a range of asset-backed securities with different risk and return profiles to microfinance investors
- Blended-value funds, offering below-market returns to socially focused investors and providing a mix of debt and equity finance to MFIs
- Holding companies of microfinance banks providing mainly equity finance and technical assistance to start-up microfinance banks
- Private equity funds seeking a market return

To simplify CGAP (as cited in Lapenu & Brusky, 2010) reduced these categories to three main types, including MIVs (such as public placement funds, private placement funds, cooperative companies/NGOs, CDOs), holding companies and other microfinance investment intermediaries. These types may be distinguished by investor types, investment types (equity, fixed income or mixed assets), structures, objectives (donation-oriented or commercially-focused), and geographical distribution (rural versus urban). These are vehicles or institutions that receive money from investors through issuance of shares, bonds and other financial instruments then channel funds to the microfinance sector, providing equity, debt and guarantees to microfinance institutions and non-specialized financial intermediaries, either self-managed or under the control of an investment management firm or a trustee (CGAP, 2007b).

3.2 Why are Microfinance Funds linked to Microfinance Institutions?

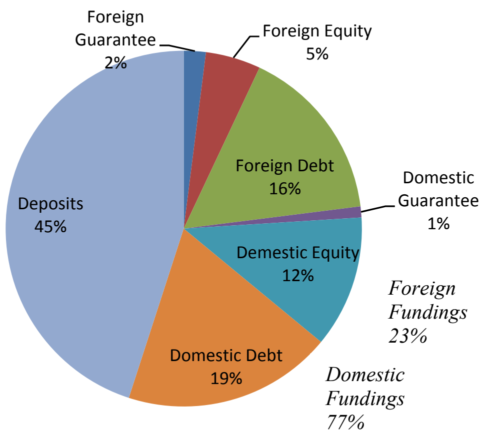
Microfinance first started with the social objective of alleviating poverty and empowering the marginalized by providing seed money for income generation. Approximately 560 million families, 2.8 billion people, are living on less than US$2 per day PPP (Purchasing Power Parity), and of those, the poorest 1.2 billion are people living on less than US$1 per day PPP. In spite of this, fewer than 18 percent have access to financial services (Meehan, 2004) and microfinance services would need to be dramatically increased to meet the demand of millions of economically active poor households across the world. Although there has been a sharp rise in microfinance loans in the last eight years, from an estimated US$ 2 billion in 2001 to around US$ 44 billion in 2008[24], current levels are still unable to meet more than a small proportion of

[24] Data obtained MIX market, http://mixmarket.org/

demand from potential borrowers, as existing sources of funding are insufficient to finance MFIs to meet their clients' demand.

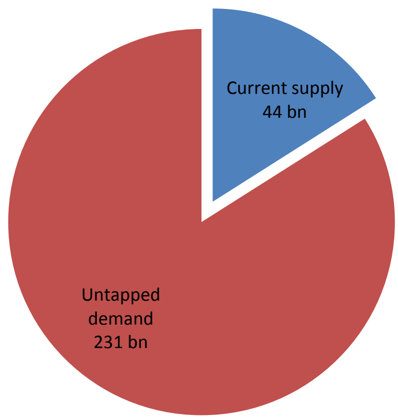
All stakeholders are now in the process of figuring out how best to increase access to financial services for the disenfranchised millions. As already seen in section: 2.3.2, in the past, the majority of funding for MFIs was grants, donations and subsidized loans from aid organizations, governments and public institutions. Over time, these sources are shrinking in the face of rapid increase in demand. As a matter of fact, the current supply of microfinance loans is significantly less than the number of unserved micro-borrowers. It is estimated that the microfinance sector still faces an immense funding gap of around US$231 billion (see Figure: 3.3) to fully meet demand in the long term, approximately US$ 275 billion in total funding composed of debt, subordinated debt, equity, deposits and guarantee for MFIs (Dieckmann, 2007). To address this untapped demand and the shortage of funding, while increasing the numbers of MFIs globally, for most MFIs seeking alternative sources of funding is necessary and absolutely indispensable.

Figure 3.2: Funding Sources of



Source: Christian Novak, ¨Microfinance: Global overview and some controversies¨, April 2011

Figure 3.3: Current Supply of Microloan



Source: Data obtained from MIX Market, and Deutsche Bank Research 2007

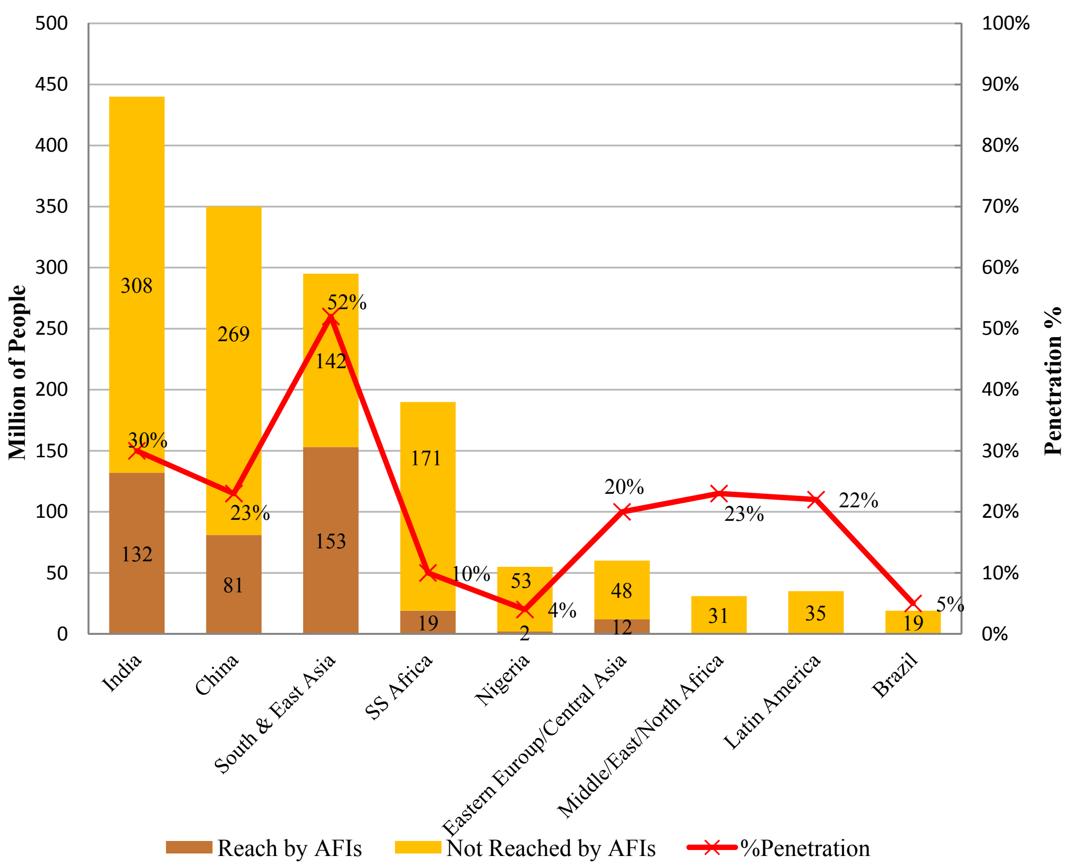
As they grow, some MFIs mature into large business operations which require different sources of funding. Typically, mature MFIs need a large volume of funding over longer term, to complement their available capital and saving mobilizations. Such longer term funding provides MFIs with a stable and diversified source of cash to fuel portfolio growth and enable them to diversify their current financial products and services. Meanwhile, even some regulated microfinance institutions are authorized to take deposits, known as the main funding source, representing 41 percent of all assets in 2005 (Sengupta & Aubuchon, 2008). Still this savings mobilization currently is not yet viable and scalable to sufficiently solve the overall funding problem. In many economies savings have not yet been well practiced, and only a few MFIs are able to take deposits, while others, microfinance NGOs and nonbank MFIs for example, are prohibited from doing so. Deposit amounts are often not reliable in the short-term, even if in the long run it is one of the main financial sustainable sources (Köhn & Jainzik, 2005). Thus savings mobilization is not an adequate solution for long term financing issues, and the funding gap remains a critical problem for many MFIs.

Some microfinance institutions have diversified funding sources, not only to gather public savings, but also to directly or indirectly access the capital market to obtain financing from domestic and foreign investors (see Figure: 3.2). The microfinance industry is progressively turning to the financial markets to absorb more capital, either through equity financing or commercial debt to finance continuities, to fully meet demand; and to enable microfinance to overcome the obstacle of innovating the sector, and to grow beyond what has been possible with donor and government support alone. More and more microfinance institutions have attracted a growing number of private investors and capital market investment managers, thanks to the particular risks and performance characteristics of microfinance (see detail in next section: 3.9.2), including low default rates, high repayment rates and high interest rates on microloans, which potentially enable a significant financial return on investment to their investors.

Moreover, the microfinance market has diversified, as some MFIs are becoming financially sustainable and more creditworthy. The characteristics of microfinance assets may constitute an advantage over other asset investments. The first microfinance investment fund, ProFund, was developed and launched in the early 1990s by development agencies to prove the real possibility of investing in microfinance. Since then, other initiatives have rapidly followed, and have set up microfinance investment funds to provide MFIs with debt, equity and guarantees. The emergence of microfinance investment funds has addressed the need for long term, sustainable financing in MFIs, and to provide attractive investment opportunities for investors.

These new investment funds are good news for both microfinance service providers and investors. The more investment in microfinance, enabling MFIs to achieve the funding required to scale-up outreach through expanding the range of available financial products and services, and increasing the depth of outreach to include a greater number of poor and non-poor who were previously excluded by formal financial system. Debt and equity instruments further diversify funding sources and create a more stable financial structure, with longer term capital, helping MFIs achieve sustainability. The opportunities of microfinance investment funds are influenced by microfinance market potential, as the penetration of microfinance services to the target population is still low, on a global basis, representing a huge gap between supply of and demand for microfinance services (see Figure 3.4). It is tempting to believe that this gap could be fully or partially met through microfinance funds.

Figure 3.4: Microfinance Market Potential



Source: Christian Novak, ¨Microfinance: Global overview and some controversies¨, April 2011; AFIs: Alternative Financial Institutions where have social objectives and target clients below the level of commercial banks, even though they also serve the non-poor. They include MFIs, Co ops, credit- unions, bank (state, rural and post)

(Source: Christian Novak, Microfinance: Global overview and some controversies, April 2011; AFIs: Alternative Financial Institutions that have social objectives and target clients below the level of commercial banks, even though they also serve the non-poor. They include MFIs, co-ops, credit unions, bank (state, rural and post)

3.3 Growth of Microfinance Funds

The growth of MFIs is intrinsically linked to growth in demand for microfinance services, which also drives the entry of new investment funds and investors. As Damian von Staffenburg (as cited in Pattillo, 2006) says, the growth in the number of microfinance investment funds is one of the great achievements of microfinance. The increase in demand for funding in the microfinance sector means inputs from investment funds have grown significantly over the last years, particularly prior to the global financial crisis, with an increase in assets under management and a more than doubling in the number of funds, from 43 in 2004 to 102 in 2012 MIVs (2.4 times).[25] As Figure: 3.5, shows, between 2005 to 2009 total assets under management has rapidly risen from US$1.5 billion to US$6 billion, of which 53% represents asset under management of top 5 microfinance funds[26].

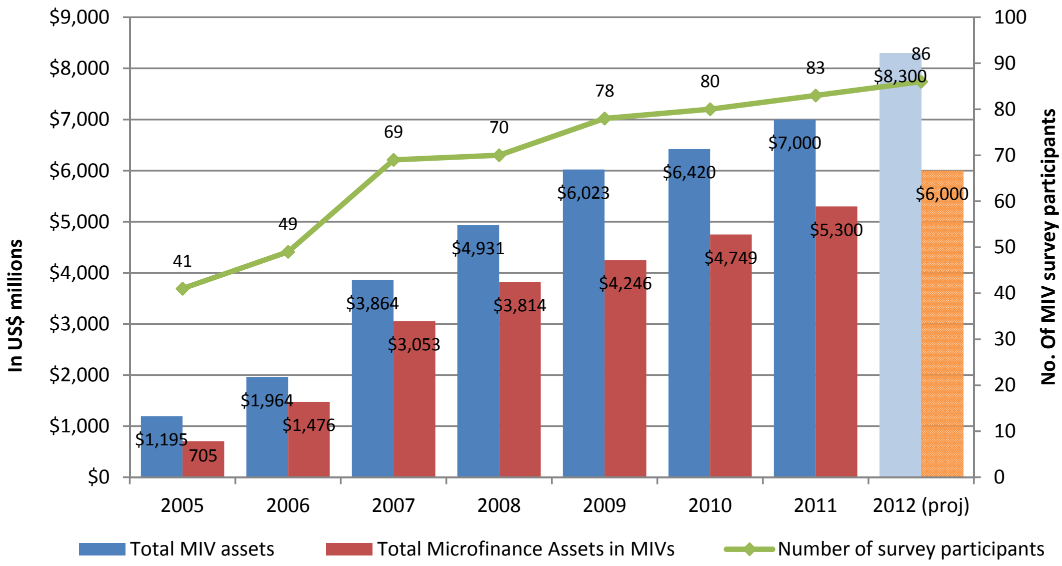
From late of 2009 to 2011, the increase in assets under management was slowing; the slow-down of growth in MIV total assets was dramatic, especially when compared to the growth rate in 2008: 28%, after a high of 97% in 2007, and thereafter a steady decrease every year to a 9% rate in 2011 (see Figure: 3.6). The global financial crisis in 2008 was a major cause for the decline in microfinance institutions' demand for funding in late 2009 and early 2010. The lag in MIV asset growth did not cause MFIs to reduce their activities, because MFIs may shift to increasing demand for local borrowing, while local funding has been expanding and offering very competitive local currency loan rates. The slowdown in demand for MFIs led to an oversupply in capital, that fund managers in certain markets need to seek for overheating countries such as Peru, Kygystan, and Cambodia to invest to avoid reducing financial return

[25] CGAP, MIV survey 2010

[26] CGAP Publications: CGAP 2007 MIV Benchmarks - CGAP 2008 MIV Benchmarks - CGAP 2009 MIV Benchmarks

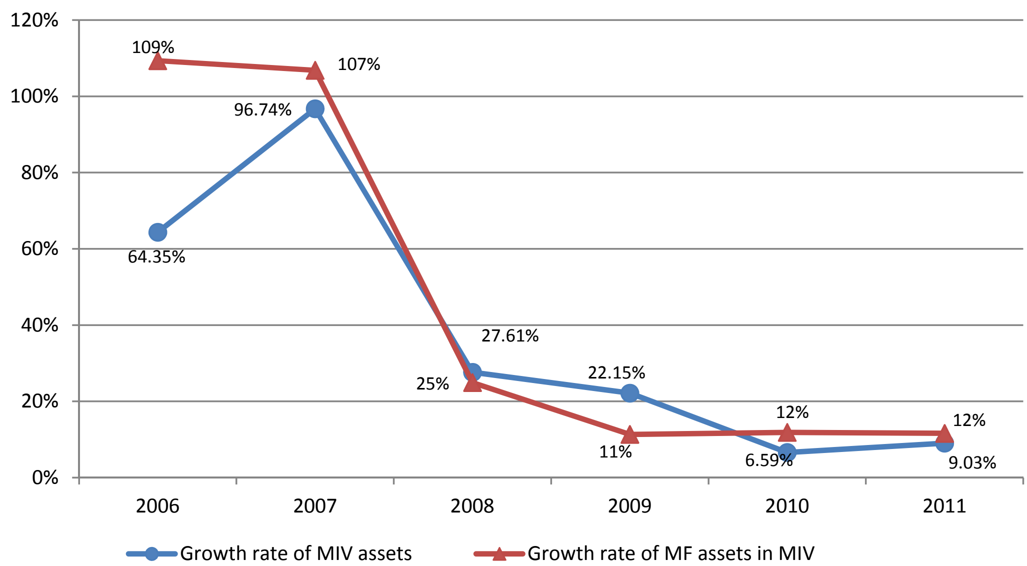
(Microrate, 2010).

Figure 3.5: Growth in MIV Assets 2005 - 2012



(*Source: Data combined from MicroRate MIVs survey 2010, 2011, 2012*)

Figure 3.6: Growth Rate of MIV Assets 2006 - 20111



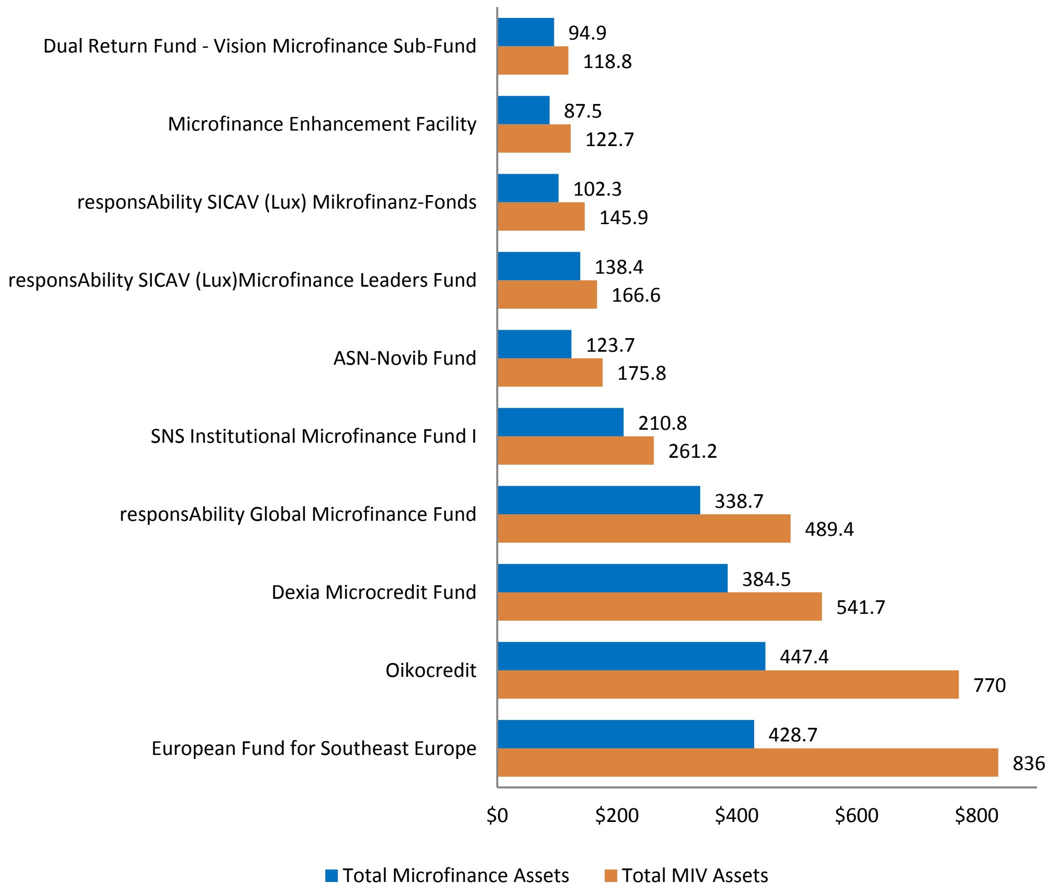
(*Source: The calculation base on data in above figure*)

Improvements in emerging markets since the middle of 2010 have seen the demand for funding for MFIs increase steadily. In a number of countries, official agencies, domestic and international Development Finance Institutions (DFIs) are progressively competing to fund a limited number of investible MFIs targets. The average MIV investment amount increased from US$1.4 million in 2009 to US$1.7 million in 2010. The majority of microfinance investments were made in Latin America and Caribbean (LAC), and Eastern Europe and Central Asia (ECA), covering 76% of total investment distribution in 2008, which fell to 73% in 2010 and 71% in 2011. The continuing decrease in investment in these regions can be attributed to the financial crisis in Europe, which caused a reduction in portfolio investment in ECA. However, both regions still dominate.

Microfinance investment funds are recognized as an important tool to bridge the funding gap in microfinance for the long term development and sustainability of the sector. However, these funds are small in terms of fund size and microfinance portfolio investment. Half of them have a microfinance portfolio less than US$25 million[27]. The large microfinance assets are held by the top ten MIVs, accounted for 58% of the market in 2011. Since 2008, the percentage of microfinance assets in the top 10 MIVs has noticeably declined against 2005 figures, where 78% was recorded (Microrate, 2011). The total assets of the top 10 MIVs reached US$3.6 billion at the end of 2009, with the European Fund for Southeast Europe (EFSE) the largest MIV with total assets US$836 million, followed by Oikocredit and Dexia Microcredit Fund (see Figure: 3.7). 76 percent of all investments made in the larger (by assets), more mature microfinance institutions located in Latin America and Eastern Europe (CGAP, 2009b).

[27] Jeanette Thomas, New CGAP Report Reveals First Performance Figures on Microfinance Funds, http://www.cgap.org/p/site/c/template.rc/1.26.1910/

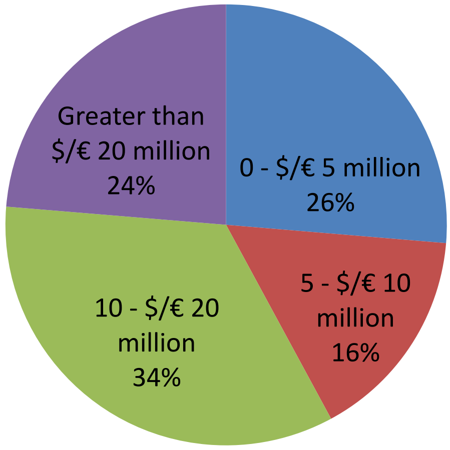
Figure 3.7: Top 10 MIVs by Microfinance Assets (US$ millions)



(*Source: Data obtained from CGAP Challenging Times: Do MIVs Need A New Investment Strategy?, May, 2010, http://www.cgap.org*)

Additionally, the sizes of funds are too small to achieve economies of scale and to be viable on their own in the long term. Microfinance investment funds require fund size at least US$20 million for financial sustainability. Yet, as shown in the Figure: 3.8, the majority of funds failed to meet this minimum sustainable size: of the 38 funds surveyed, 76% were below the line, compared to 24% (only nine funds) above (Goodman, 2006). Small funds need to spend more on start-up costs and fixed costs, which represent a relatively high proportion of their assets and provide lower return to investors.

Figure 3.8: Size of Microfinance Funds



Source: Patrick Goodman, ¨Microfinance Investment Fund: Objective, Players, Potential¨, 2004
(*Source: Patrick Goodman, Microfinance Investment Fund: Objective, Players, Potential, 2004*)

Since the unique characteristics of microfinance funds is the importance of a positive social impact from money invested, it is not easy for fund managers to balance reasonable social and financial returns, and to minimize coherent risk. Microfinance investment funds can be distinguished by particular investment strategies that provide a mix of financial, risk, and social performance. Investors can, in turn, make investment decisions by arranging their own priorities, scrutinizing strategies and performance, and selecting funds that best match their preferences. However, the growing number and variety of microfinance funds may complicate the decision making process. As the industry matures, existing and potential investors have difficulty comparing and examining those funds due to the lack of accessible, standardized, transparent information, and the objective third party analysis.

Hence it is necessary to introduce greater transparency and accountability amongst fund managers, to establish performance standards to promote safe and sound investments, and to ensure healthy growth for the future (Ivatury &

Reille, 2004). Meanwhile, both microfinance funds and MFIs lack mechanisms to control and reduce risks, particularly foreign exchange risk. Some funds are choosing to quickly copy foreign exchange risk mechanisms and strategies used by mainstream investment banks; in this case MFIs need to raise capital on *domestic* markets through savings mobilization and local capital markets where they are available. Furthermore, MicroRate's study of 47 funds in 2011 found the factors that hindered the growth of microfinance funds included government regulation, negative publicity about microfinance, and a lack of demand from investible MFIs. On the other hand, the improvement of MFI credit fundamentals, increased demand from MFIs, stabilization and enhancement of economies for investment post-crisis were the factors to enhance microfinance investment fund to grow (Microrate, 2011).

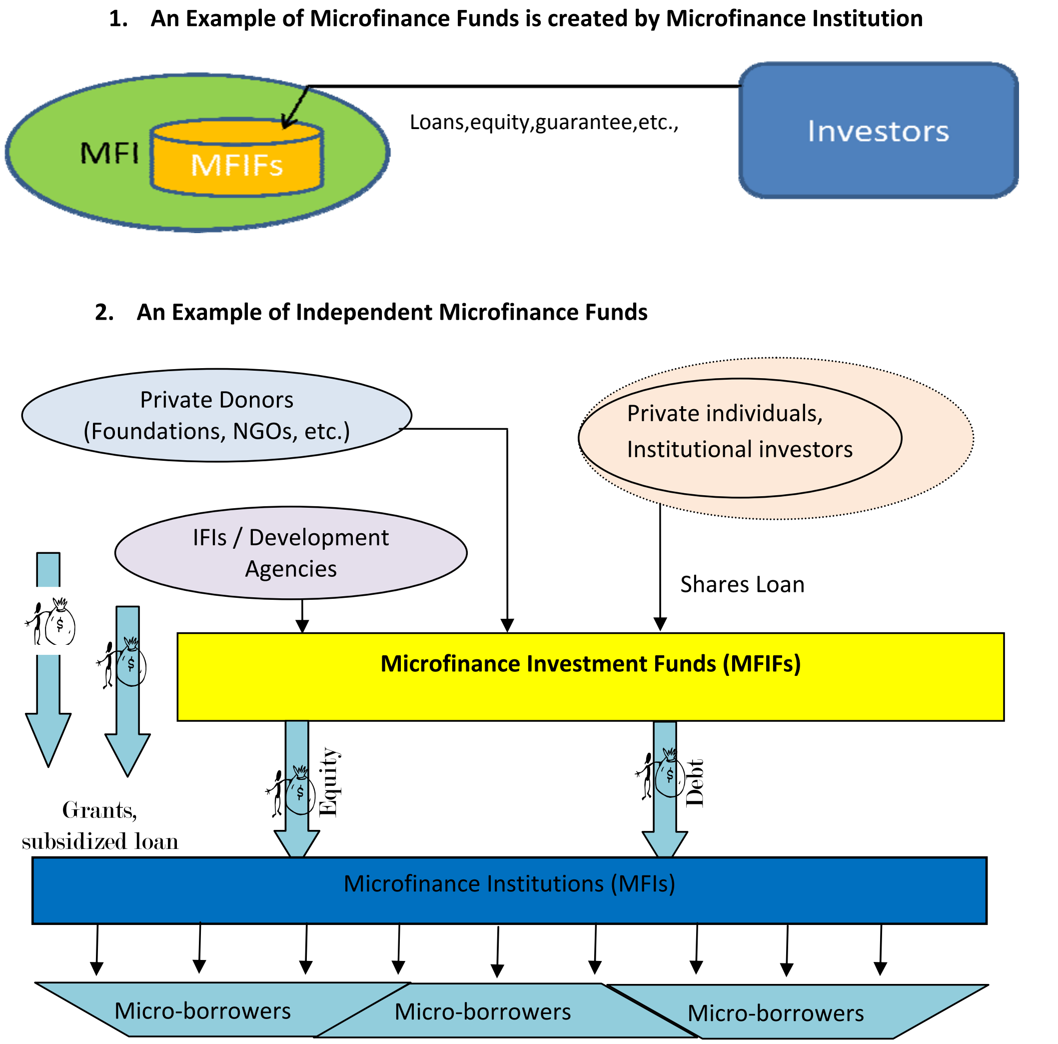
3.4 Sources of Funding in Microfinance Funds

Funds have different funding sources, due to a diverse investment approach regarding social returns and financial returns. The more socially focused are generally funded by development agencies and private donors, while commercial investors and socially responsible investors fund the more financially focused (Galema & Lensink, 2009). The capital of some microfinance funds is highly illiquid; the market price is basically what an investor is prepared to pay. A greater consistency between sources of microfinance investments will be necessary as with an increase in equity investments and as more investors buy in.

With the increased need for extension of financial resources, investment funds can be established either by some MFIs being formalized for profit making, and for sustainable operations to continue offering services to the poor (Goodman, 2006), or by independent institutions or fund managers managing and investing in the right microfinance providers (see example of funding flow in Figure 3.9). Investors can not only make a direct investment in a microfinance investment fund, which in turn invests in a MFI, but also an indirect investment via a fund-of-funds, which in turn invests in a fund. Simultaneously, microfinance investment funds can invest directly or indirectly into a microfinance portfolio.

According to CGAP, *direct microfinance portfolio investment* refers to funds directly invested into equity or debt instruments issued by MFIs in emerging and developing countries, or loans to non-specialized financial intermediaries, specifically used to fund microloans directly. Where investors invest in a collateral debt obligation (CDO) or other microfinance investment vehicle, rather than direct debt to an MFI, or provide loans to non-specialized financial intermediaries specifically used to fund MFIs, this is called *indirect microfinance portfolio investment*. For example, *AXA World Funds-Development Debt* is a sub-fund of AXA World Fund, Luxembourg Fund, has a policy of participating in sustainable development of emerging economies. Besides purchasing debt instruments from Development Financial Institutions, this sub-fund also invested up to 10% in commercial paper issued by MFIs.

Figure 3.9: An Example Channel of Funding into Microfinance Institution

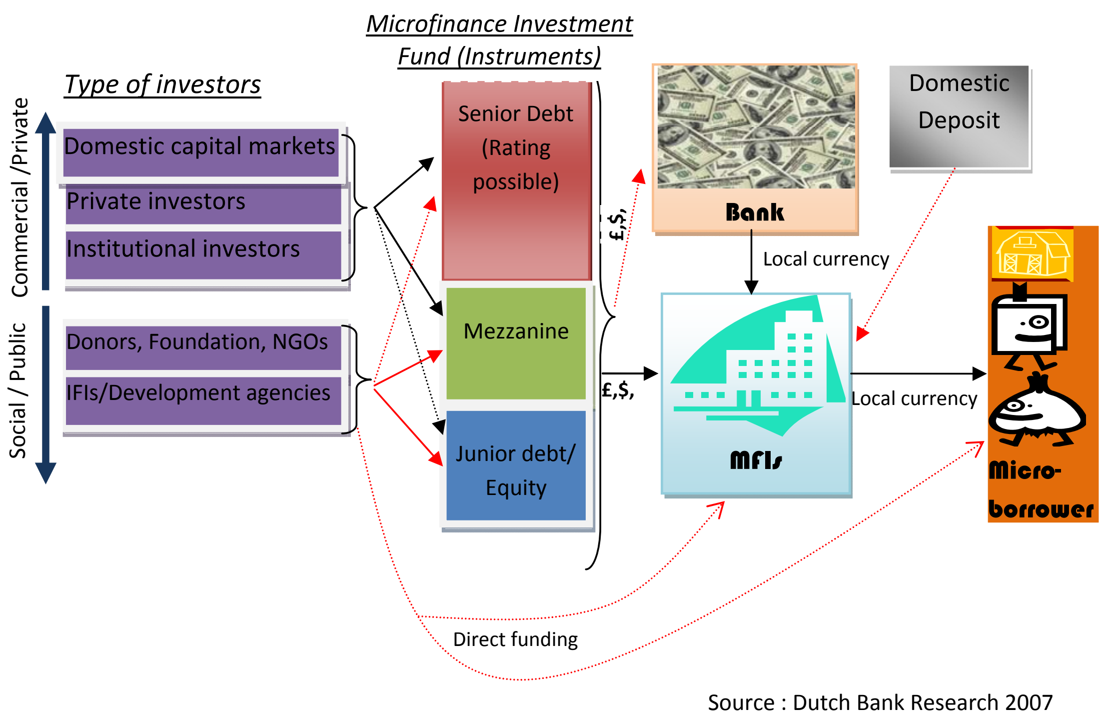


Source: Microfinance Investment Funds: Objectives, Players, Potential

Microfinance funds can invest some portion of their assets in microfinance institutions, either directly or through dedicated investment funds (Goodman, 2006). The size of investment varies in ranges depending on the type of investors and instruments (discussed in section: 3.5 and section: 3.6). In general, most microfinance funds target wealthy investors, often with a minimum amount of investment US$100,000, although some funds also promote more opportunities for smaller investors to invest, as low as US$1,000 (R. E. Silverman, 2006).

Funds typically deal with debt, equity, or guarantee transactions (see section: 3.5), investment in debt made in hard currency being the most common transaction. However, to support the growth of the industry and its risk management, it is critical that investments are done in local currency. As this sector is still in its infancy, equity transactions are not as prevalent. Investors can choose to invest in diverse funds with various investment instruments including senior debt, mezzanine, junior debt/equity, bond-like securities that are ultimately backed by thousands of tiny loans, and loan guarantees (see an example in Figure 3.10). These are offered based on the degree of risk and return, maturities, prices and so on.

Figure 3.10: An Example of Investment Instruments of Microfinance Funds



3.5 Microfinance Financing Instrument

3.5.1 Debt Financing

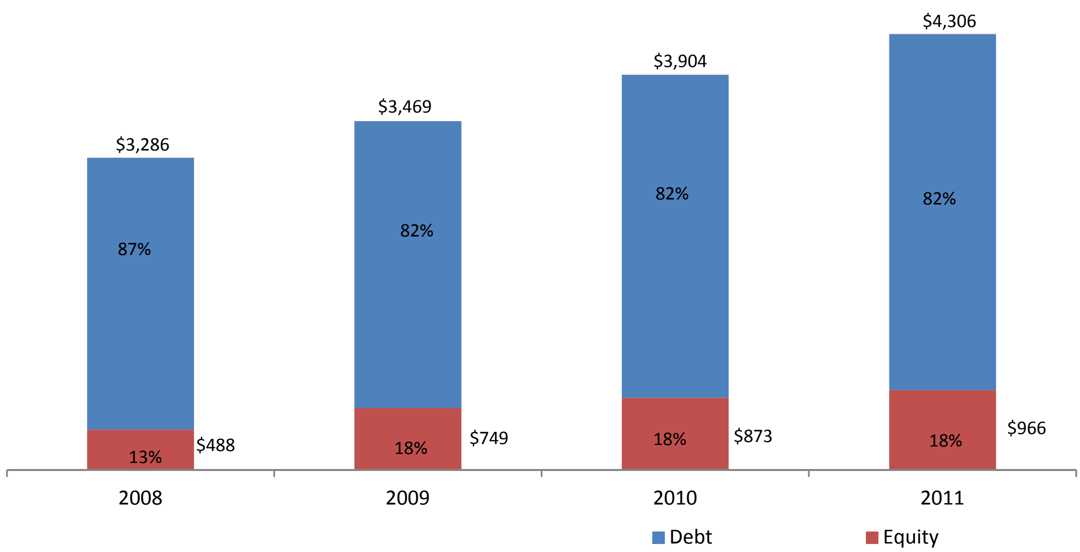
Most microfinance funds are debt instruments which make loans to MFIs and generate interest income for investors. Currently, the international debt market is an almost endless source of funds, and is always attractive for MFIs, especially because they usually charge lower interest rates; however, they have certain structural requirements that most MFIs are not ready to meet. Debt investment can be expected to provide annual returns to an investor of anywhere from 1 to 5% [28]. In response to the more complex capital structure and rising competition in the sector, structured debt products have developed and diversified throughout the early 2000s including *bonds, collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs)*, as well as *securitization of microfinance portfolios* (Cheng, 2011), more subordinated debt offerings and the tenure of senior debt lengthening from two to three or even four years (Microrate, 2012).

Microfinance assets held by investment funds are primarily debt. Figure: 3.11 shows that debt investment in MFIs represented 82% of all microfinance investment in 2011, down from 87% in 2008. Remarkably, fixed-income return has also dropped from historically high rates, more than 5% to 2.5% in 2010, which may not provide attractive risk-return for investors (Reille et al., 2011). The constant decline in debt investment can in part be attributed to MFIs reducing foreign borrowing to look for more domestic funding opportunities, including local commercial debt and savings mobilization where possible. In fact, while most MFIs seek more collecting public savings, this share had increased from 43% to 57%, and this trend may continue, leaving more

[28] Rachel Emma Silverman "A new way to do well by doing good: Microfinance Funds Earn, Return on Tiny Loans, To Poor Entrepreneurs Abroad", The Wall Street Journal, 2006

uninvested capital that yields very little income. Development Financial Institutions (DFIs) have also increased investment in microfinance institutions: 70% of direct investments were made in debt, the majority in hard currency, while the vast majority of private investors make debt investments through microfinance funds (Reille et al., 2011). Debt financing is usually made in well-established, top-tier, mature institutions for funding the growth of portfolio and refinancing maturing debt (Ledgerwood, 2012).

Figure 3.11: Financing Instrument



(*Source: MicroRate "The State of Microfinance Investment 2012"*)

The overwhelming majority of new capital in the microfinance industry is debt or subordinated debt rather than equity. For instance, in July 2004, BlueOchard Securities I issued a *40million-bond*, structured in 4 tranches, and sold to investors to fund nine microfinance institutions in developing countries (seven MFIs in Latin America, one in Cambodia, and one in Russia), to tap the US capital markets for lower cost, longer term financing, ultimately providing approximately 40,000 new loans to micro-entrepreneurs. Critical to complete the seven year deal was bringing together different investors through multiple tranches to appeal to different risk-return appetites. The bond issue had 66 purchasers: 12 foundations, 15 MFI practitioners, 11 Socially Responsible Investment Asset Managers and three Socially Responsible Investment fund (Meehan, 2004).

In addition, BlueOrchard developed the first *CDO*, in collaboration with Developing World Markets (a corporate finance consultancy) only offering short-term maturities, which ultimately limited its appeal to both investors and MFIs. CDOs overcame the limitations of earlier funds, and resulted in longer term loans to MFIs, attracting a larger and broader investor audience, and generating higher rates of return. The success of CDOs was also assisted by the Overseas Private Investment Company (OPIC) providing a guarantee to reduce investors' perceptions of risk (Cheng, 2011).

Securitization of microfinance loan portfolio typically involves the conversion of a pooled microloan with predictable future cash flow into securities that are tradable in the capital market (microloan-backed securities). This meant that MFIs sell the right to income from microloans to investors, who rely on the abilities of the underlying microloan borrowers to repay their loans, whereas CDOs rely on the ability of the MFI to repay a loan. CDOs are a new tool to bring mainstream investors to microfinance, but they require a creditworthiness rating, limiting their scope (Sengupta & Aubuchon, 2008). Securitization can be a useful tool to spread credit risk, increase liquidity, reach new investors, reduce funding costs and move assets off an MFI balance sheet, thereby reducing the capital adequacy ratio and freeing up capital to leverage new debt (Ledgerwood, 2012).

In general, loans with homogeneous market risks can be packed to offer, for example, mortgage loans, credit card debt, auto and consumer loans (USAID, 2007). For example, Bangladesh-based NGO BRAC[29], in 2006, securitized US$180 million in microfinance receivables, the first deal of its kind in the world. This transaction, structured by RSA Capital, Citigroup, the Netherlands Development Finance Company (FMO) and Germany's KfW bank, provides financing for BRAC over a period of six years, in a stream of one-year note issuance (Reddy, 2007). SHARE in India made a small securitization of US$4.3 million, sold entirely to ICICI Bank with a guarantee of around US$300,000 from the Grameen Foundation.

However, with too much debt capital creating more challenges in the sector, pricing has become less attractive for debt investors who are seeking financial returns. Many microfinance institutions (MFIs) have reached leverage limits, or are seeking to decrease leverage as a defensive measure in light of the global economic slowdown. In addition, many MFIs have transformed regulated entities, creating an ownership structure that facilitates shareholder capital. Consequently, investors and MFIs have been exploring equity investment opportunities more aggressively.

3.5.2 Equity Financing

Investment in microfinance began in the late 1990s with equity, appearing simultaneously with the commercialization of microfinance and the creation of the first shareholder-owned MFIs. The first equity investors in MFIs were public sector development banks and not-for-profit organizations, with a shift to private investors evident over the last decade. Equity investment is usually done to start up business when institutions cannot access bank loans due to lack of a credit record or collateral, so they need to look for a venture capitalist who

[29]BRAC is the largest non-governmental development organization in the world, measured by number of employees and the number of people it has helped; established in 1972

can share risk and rewards. Equity investment is used to support regulatory requirements, to secure other types of financing by acting as a financial cushion that provides more comfort for the lender to provide loans (Ledgerwood, 2012), and to expand access to financial services in frontier markets through the creation of new financial institutions and the expansion of existing ones (Reille et al., 2011). Investment in equity carries more risk and involves a longer investment term, and the investor can expect annualized net returns about 5% to 10%.

Microfinance funds have shifted from debt favor to equity, with a rise in equity investment from 13% in 2008 to 18% in 2011 (see Figure 3.11). The growth of equity can be a function of the decrease in loan or debt investment (as disscused in the previous section) or an increase in market value. In fact, while the demand for foreign debt is decreasing, foreign equity investment in microfinance has been booming, growing to US$2 billion, 18% of foreign investment (Reille et al., 2011). Several microfinance investment vehicles (MIVs) that previously invested exclusively in debt have been allocating a percentage of their portfolios to equity as well, and at the end of 2008 there were 24 specialized equity funds were managing a total of US$1.5 billion (CGAP & Morgan, 2009).

Institutional investors, like leading pension funds TIAA-CREF in the US and ABP in Europe are including asset allocation in specialized microfinance equity funds over US$100 million as part of their socially responsible investment (SRI) strategies. The increase in equity investments has also been stimulated by the success of Initial Public Offerings (IPOs) of MFIs eager to access large amounts of capital at favorable rates. Only the largest and most efficient organizations, located in countries with well-functioning stock markets, have been capable of making this transition. Bank Rakyat in Indonesia, BRAC in Bangladesh, Equity Bank in Kenya, Banco Compartamos in Mexico and SKS in India are the best examples of transactions in which initial investors saw returns that were several times the value of their originally invested capital.

However, the rising microfinance equity market presents both attractive opportunities and obstacles for investors. The pool of investible MFIs are limited; the number of investment-ready MFIs is small and expanding much slower than the speed of equity supply. Some equity investments in MFIs have been executed by multilateral and bilateral donors such as ACCION International, cooperative members, and socially focused investment such as Oikocredit and Alterfin which are investing in young MFIs with an investment size below US$500,000 (Reille et al., 2011). Limitations include the shortage of secondary or alternative exit options, difficulty in valuation, and governance issues such as dissimilar views on organizational vision and mission among the founders and new, perhaps more market-oriented management.

Most equity investments are non-commercial. Profund, which was incorporated in Costa Rica in 1995, is one of the few examples of a commercial investment fund making the first equity investments in MFIs, with their focus on Latin America and the Caribbean. For credit cooperatives, members' equity is another funding source (Ueno et al., 2006). Ultimately, most advanced MFIs are ready to access local and international capital markets to fund their portfolios, using funding strategies which already exist in the capital market but are relatively new to the microfinance industry, to absorb commercial investment in microfinance as well as to attract more investors.

3.5.3 Loan Guarantee

Loan guarantees are a form of credit insurance for lenders (i.e. local commercial bank) to mitigate default risks (Mark, 2007). In order to get a loan from a commercial bank, an MFI must provide formal collateral. In this case a guarantor can insure them by pledging assets or general credit, usually in the form of a standby letter of credit, which can be issued by the bank for a fee, to take responsibility for loan repayment in case of default. The issuers of the guarantee undertake to pay the guaranteed portion of loan to the bank if the MFI is unable to repay, and/or benefit from any capital gain generated by MFIs based on the agreement. A fee is payable for this insurance.

Loan guarantees are tailored to meet the needs of both borrower and creditor, and come in several forms, including standby letter, cash deposit, or promissory notes. The structure of guarantee agreements may vary widely as well, say covering a lender against any source of default or only covering defaults arising from specified events. The guarantee serves as a type of credit enhancement to reduce the lender's perception of MFI default risk (Rocks, 2010). Through the guarantee, MFIs and domestic banks can promote stronger relationships for business partners. Development Finance Institutions (DFIs) and NGOs, including USAID, AFD, KfW and SIDA, are the main guarantors, while some of private initiatives such as MicroCredit Enterprises, Shared Interest, and Grameen Bank have emerged in recent years.

92 percent of guarantees are issued to local banks to facilitate MFIs getting loans, usually with the expectation that the bank will increasingly lend to MFI in the future without guarantees. Note, however, that MFIs had to pay a relatively high cost compared to their other sources (simple term loans and deposits) since they need to pay bank interest rates plus the guarantee fee (annual fees range from 0 to 4.5%). Consequently, Mark

(2007) argues guaranteed loans do not significantly increase total funding of MFIs. It can be important in building long-term relationships with commercial banks, improving funding diversification, and in creating a competitive funding structure.

Guarantees are an important component in the process of commercialization of the microfinance. If a MFI is unable to attract financing on its own, either because it is a start-up with limited track-record, is located in a risky country, or for some is not seen as investible, guarantee provide commercial investors with a cushioned entry into microfinance investment. This not only progressively increases the volume of funding available to MFIs, but also allows them to diversify their funding sources, providing them with a more stable base. This in turn helps MFIs to improve their professional liability management, as commercial investors typically undertake more rigorous due diligence processes than donors. Yet only a small number of guarantees are used to facilitate the large pool of international commercial capital as a mechanism to reduce risk for international MFI lenders (Mark, 2007).

A major benefit provided by guarantees is protection for MFIs from currency risk. The guarantor can fix the guarantee amount in hard currency while the local bank lends to the MFI in local currency, leaving the MFI with no exchange risk, and the guarantor or the local bank with relatively minor exchange risk in the event of default. Under this arrangement, a MFI can borrow in its local currency, so currency conversion would only take place in the event of a default resulting in a capital call. However, guarantees are effective when they are used to structure loans to MFIs under conditions more favorable than typical bank loans. The loan guarantee approach is often used in riskier situations, such as with new MFIs or the introduction of new products. They may incorporate additional forms of support such as technical assistance or consulting services in order to help the investment succeed.

Although guarantees are not always appropriate for all MFIs, and can sometimes be more expensive and less catalytic than intended, they can be powerful tools for leveraging guarantor capital, enabling local currency funding with low foreign exchange risk, and overcoming regulatory hurdles to foreign investment. While the microfinance sector maturing, loan guarantees have diminished both in relative and absolute terms, from 1% (US$35 million) in 2007 to 0.13% (US$9 million) of assets under management in 2011 (Microrate, 2012).

Besides the expensive transaction costs, concerning issues include information, risk, and compensation. Information gathering, analysis and monitoring are crucial but often costly. This burden must be divided between the guarantor and the lender to avoid duplication of work. Given the relatively high amount of risk involved in guarantee schemes, it is important to divide risk among a pool of guarantors according to the risk appetite of each. The risk premium must be shared appropriately among these entities as well. Removing too much of an MFI's risk may be problematic, potentially leading to negligence in the client screening process and subsequent monitoring.

How loan guarantees work: According to (Mark, 2007) loan guarantees often involve at least three parties. The guarantor may use the following mechanism in the transaction:

- *Standby Letter of Credit (SBLOC)*: Four institutions are involved in this transaction. The guarantor deposits the guaranteed amount in an international bank that issues an SBLOC to a local bank, which then extends the loan to the MFI. In case of default, the international bank repays the local bank based on the percentage of guaranteed amount.
- *Direct deposit in the lending institution*: The guarantor deposits the guaranteed mount directly in a local bank. In this case the guarantor

is exposed to local bank failure and host currency repatriation.

- *Loans to MFI that are deposited in a lending institution*: Technically, the guarantor extends a loan to an MFI, but this loan is used as a guarantee. The guarantor lends to the MFI, which deposits the same amount in a lending institution, which then extends the loan back to the MFIs.

3.6 Types of Microfinance Investors

The broad range of organizations that fund microfinance funds extend from NGOs and development agencies to commercial players. In recent years a number of microfinance investment funds have received more interest from investors after establishing an increasing number of investment structures to fund MFIs. Funds provide investment opportunities to both domestic and international investors to indirectly invest in a wider range of MFI's portfolio. A variety of private investors, ranging from retail investors, high net worth individuals, and institutional investors, are increasingly seeking for efficient ways to flow capital into microfinance. These investors are often considered social responsible investors focused on the double bottom line (financial as well as social returns). Some investors may also be looking for a reputational cachet through investment in microfinance adding to financial returns (Köhn & Jainzik, 2005). They then gradually started to provide subsidized loans at little or no interest. Some private donors have advocated interest rates closer to market conditions for the most mature MFIs they finance. The type of investors who are financing microfinance institutions either directly or through microfinance investment funds are defined as follows.

- **Public investor**: including *private donors* and *development agencies.* Foundations and NGOs funded by corporations and private individual are classified as *private donors*. They have played an important role in development of microfinance by directly supporting and creating MFIs through grants, donations, technical assistance and subsidies. After that, they gradually started to provide subsidized loans at little or no interest. They are increasingly active in microfinance as they see this sector as an effective way of contributing to the social welfare of the poorest. Most mature MFIs have been financed by private donors and charge interest rates closer to market conditions.

Development Agencies are also referred to as bilateral and multilateral agencies, consisting of international financial institutions (IFIs) and development finance institutions (DFIs). Development agencies have been created by government and supranational bodies as an instrument to facilitate and promote MFIs in emerging countries for sustainable growth, initially directly through grants, subsidized loans and equity participation (Goodman, 2006). DFIs brought a commercial approach to the industry, providing quasi-commercial loans, equity and guarantees to MFIs capable of scale and profitability. The official role of a DFI is to foster private investment in developing countries; examples include BIO, FMO, IFC, KfW, and USAID.

- **Private individuals**: Since the late 1990s there are increasing numbers of private investors either investing directly or through broker dealers into investment funds. The dual objective of investment funds, offering both a social and a financial return, more and more motivate and attract individuals as investors. Oikocredit, a Dutch cooperative society established in 1975 by the World Council of Churches, was one of the first organizations to raise retail investment for microfinance. The Community Investment Note was launched in 1995 by Calvert Social Investment Foundation, which is accessible to private investors. Recently, more individuals invest in microfinance through online, peer-to peer lending initiatives, such as Kiva[30]. The high net worth individual has also started to engage: typically, successful entrepreneurs who provide the benefit of both their investment and business skills to help MFIs to extend scale. Example, Pierre Omidyare, founder of eBay, donated US$100 million to Tufts University to create the Omidyar-Tufts Microfinance Fund (Reille & Forster, 2008).

- **Institutional investors**: Institutional investors include international banks, pension funds, insurance companies, mutual and investment funds, private equity funds, and other large-scale investors who are interested in investment in microfinance. These are usually for-profit investors, generally do not directly invest in microfinance institutions but in funds or companies that are organized for the purpose of investing in microfinance. These investors understand the advantages of microfinance investment and are focused on a narrow niche market of high-growth MFIs to diversify the risk of their investment and offer competitive market returns. International banks were the first institutional investors in microfinance, initially from a philanthropic motivation, and have developed financing techniques for both direct and indirect investment in MFIs.

  Deutsche Bank, for example, was the first commercial bank to establish a fund for MFIs in 1998, through its philanthropic arm, Deutsche Bank America Foundation (Reille & Forster, 2008). Subsequently, *AXA World Fund-Development Debt* a sub-fund of AXA World Funds in Luxembourg, followed suit, either directly or through investment funds. Some institutional investors, despite having little understanding

[30]Kiva is a non-profit organization with a mission to connect people through lending to alleviate poverty. Leveraging the internet and a worldwide network microfinance institutions, Kiva lets individuals lend as little as $25 to help create opportunity around the world. available at: http://www.kiva.org/about

of the microfinance industry and no intention of developing their own microfinance expertise, can diversify their investments and risk through microfinance investment funds.

3.7 Types of Microfinance Investment Fund

Microfinance investment funds can be classified in three main types depending on the level of commercial orientation:

1. **Commercial microfinance investment funds**: These funds tend to invest exclusively in the most mature microfinance institutions. Private and institutional investors are the main target of commercial microfinance investment funds, while development agencies and private donors appear only as initial investors, or as facilitators or risk takers by investing in subordination tranches. In general, a commercial institutional investor desires to know and understand clearly how these investment funds operate, their methodologies, expected financial return, and which MFIs are financed. The commercial investor may require precise, transparent and accountable official reports and information from investment fund that development agencies and private donor do not request. Ratings and formal comprehensive financial reporting may be required to meet internal criteria on investment selection (Dieckmann, 2007).

   Without a market-rate of return, adjusted for risk to the investor, funds may lose potential investors to other opportunities. Commercial funds mainly invest in debts to MFIs, and only a few funds hold small equity, in contrast to development agencies and private donors that largely invest in equity in MFIs (Maier & Pischke, 2008). As the market matures, equity funds will also target institutional investors.

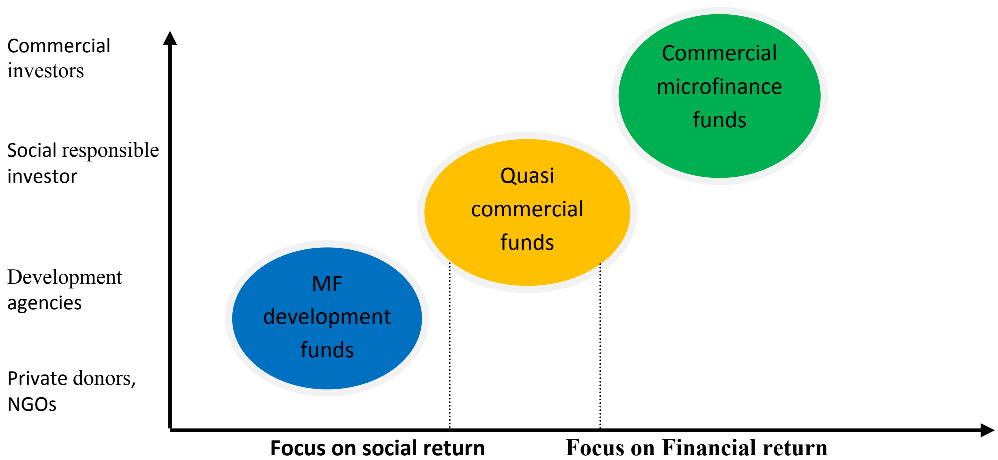
Examples of commercial microfinance investment funds are AXA World Funds, Dexia Micro-Credit Fund, Blue Orchard Debt Sub-Fund, MicroVest, Responsibility Global Microfinance Fund, Global Commercial Microfinance Consortium (Deutsche Bank), and db Microfinance-Invest Nr.1. This investment structure invests predominantly in debt instruments of MFIs.

2. **Quasi-commercial microfinance investment funds**: Also known as commercially-oriented or dual-objective microfinance investment funds, since they have the clear objective of a balance between social and financial returns. Private donors, development agencies and social responsible investors play an important role in steering these funds. The financial return is lower than market but investors in this category also seek a social return (Dieckmann, 2007). The main distinction between these funds and commercial microfinance funds is the nature of the investors targeted. Last few years, some quasi-commercial investment funds actually fared significantly better than commercial funds, essentially due to their higher proportion of equity holdings. Debt instruments are being provided to MFIs in which they invest in equity with those they want to create a long-term partnership with. They want to obtain more capital from the private sector by acting as a true public-private partnership, while maintaining the social mission of invested MFI (Maier & Pischke, 2008). Dual objective funds include AIM-ACCION Investments in Microfinance, SPC (AIM), PROFUND - ProFund International, and responsAbility Microfinance Leaders Fund.

3. **Microfinance development funds**: This category includes cooperatives and non-profit entities. The main investors are private donors, development agencies, private individuals and corporations who grant capital by expecting a social return rather than financial return,

if possible, with the purpose of maintaining the real inflation-adjusted value of their cost of capital invested. These funds usually subsidize or fund MFIs below market rates, often along with technical assistance since their objective is to make capital available to MFIs without necessarily seeking a financial return. Maybe these funds ought to prepare MFIs for access to capital markets by targeting those approaching sustainability, including development institutions. These funds do not usually provide grants and donations to MFIs because doing so would deplete capital. They diversify their microfinance portfolio mainly by investing in debt instruments. Microfinance development funds can become discouraged when they deal with investors who share their social goals only to find that the investors insisting return on investment, and security of the funds invested. Examples of current microfinance development funds are Oikocredit, Accion Gateway Fund, Deutche Bank Start-up Fund, and Incofin.

Figure 3.12: Type of Microfinance Investment Funds



(*Source: Deutsche Bank Research, 2007*)
Source: Deutsche Bank Research, 2007

3.8 The Socially Responsible Investment in Microfinance

A socially responsible investor (SRI) can be defined as an investor who seeks to maximize profits while respecting responsible corporate practices towards the various stakeholders of their investment (Roland, 2012). The SRI market is huge and growing rapidly under professional management, with over US$4 trillion in assets. SRIs comprise a wide spectrum of investors with differing expectations, from those willing to receive below-market returns to those seeking competitive returns within the context of a social mandate.

The gradual raise of socially responsible investment is a good opportunity for the microfinance industry to absorb additional financial resources, due to their unique development characteristic, to absorb more additional financial resources. Generally, microfinance institutions (MFIs) are operate on a "double bottom-line" basis that seeks to have a positive social impact alongside financial returns. Microfinance investment fund were established to extend funding sources for MFIs, initially with the objective of some financial return. Most MFIs are able to carefully combine social development objectives with financial viability. A MFI's social and financial objectives need to be balanced properly, and this issue is discussed intensively within the sector. It is often feared that a greater degree of formalization and the inclusion of private funding might distract MFIs from reaching their original social objectives. However, the reality is that, so far, the inspiration of investment in microfinance has come from investors with a social orientation aligned with their financial motivations.

In general, socially conscious investors tend towards pure financial investment with the aim of supporting and expanding social benefits (Yunus, 2007). In addition, they are becoming more sensitive to the influence of the global crisis;

investment in the microfinance sector is a very attractive proposition for a growing segment of socially responsible investors, as it is less volatile and uncorrelated to the world crisis, and they believe that emerging markets in developing countries will provide them a better opportunity for the return of the investment. There is no doubt that microfinance investment funds are suitable for the aims of socially responsible investment and they represent a better chance for those investors who attempt to obtain both social and financial returns.

Microfinance funds have attracted a large pool of socially oriented investors, including public, institutional and retail investors. For example, the first dual objective investment fund seeking that was not launched by private donors or development agencies was the Dexia Micro-Credit Fund, established in 1998 by Dexia-BIL in Luxembourg. Development investors such as IFC are very active in the microfinance market and are ramping up their microfinance portfolios in response to the global credit squeeze. Large pension funds, such as APB and TIAA-CREF, have maintained their microfinance allocation as part of their socially responsible investment strategy, although very few new investments have been announced. Retail investors have also continued to fuel the growth of microfinance funds since 2008.

3.9 Risk-Return Profile of Microfinance Funds

3.9.1 Dual Return Profile

Dual Objective

Both microfinance institutions and microfinance investment funds usually start their businesses with the dual objective. What does dual objective mean in the microfinance sector? Microfinance institutions very often begin as non-profit organizations with essentially a social objective: provision of microloans with modest interest rate to poor and low income people for a better standard of living, and they receive grants and donations to achieve these objectives. The first financial structures put in place to lend to MFIs was established by private donors and development agencies with a development objective in mind (Goodman, 2006). Profund, arguably the first microfinance investment fund established with the objective of obtaining a financial return, was initiated and essentially owned by development agencies.

As more and more private investors enter microfinance, and microfinance NGOs transform into regulated financial institutions, it is often feared that the inclusion of private funding and greater degree of formalization might lead to mission drift[31] in MFIs, that a profit focus might distract MFI from achieving their social objectives. Social and financial objectives need to be carefully balanced. Many studies discussing mission drift have not found this to be the case in recent times; MFIs are still able to achieve their original social objectives despite a greater orientation to financial returns.

We can see that investment in microfinance is driven by a double bottom line objective (dual objective) seeking both social and financial returns. For

[31] "Mission drift" refers to the possibility of activities being dominated by financial objectives, based on Deutch Bank Research in 2012

the social return, investors believe that their investments in microfinance institutions can reduce the problem of the big funding gap, secure and leverage additional funding sources, and ultimately assist growth with financial sustainability. Consequently, MFIs can meet the growth in demand of microborrowers by lending with larger loan sizes and deeper outreach. All actors, both investor and MFI, play a vital role in contributing to poverty alleviation in developing countries.

Furthermore, the nature of microfinance, focused on short term loan maturity, low default rates, strong portfolio quality, stable financial return during the global financial crisis, potentially less correlation with capital markets, especially in comparison to commercial banks in domestic countries, are all factors that appeal to socially responsible invested who wish to invest with the expectation of increased profitability. More importantly, previous researchers (Gonzalez, 2007; Krauss & Walter, 2008; Galema et al., 2011) have found that investing in microfinance is the effective way to diversify a general market portfolio of investor. This diversification benefit is based on the special feature of microfinance institutions, with their dual return profile and the fact that they are less leveraged than traditional financial institutions (see section: 3.10).

Similarly, half of all investments in microfinance from developed countries are made through microfinance investment funds, as most funds are based in western Europe and the United States, and serve as financial intermediaries between MFIs and final investors. Alongside the socially responsible characteristics of microfinance, investors also have to take into consideration financial returns from investments. Like direct investment in microfinance, indirect investment through microfinance funds also provides significant value from portfolio diversification, while their returns are unconstrained by the performance of the global market. Janda & Svárovská (2012) studied the relationship between microfinance fund returns and the performance of the stock and fixed income market in developed and emerging markets, and suggested that the return on investment in funds negatively correlate with return on market portfolio.

Microfinance investment fund returns are not only independent of the global performance of other assets (stock and bonds) but also exceed returns on the market portfolio. In addition, investment in funds is less risky than individual investment due to the diversification of fund management, indirect exposure to currency risk, and higher liquidity of investment assured by redemption rights. Therefore, inclusion of zero systematic risk of microfinance assets could be a benefit, better diversification of a broader portfolio against the impact of sentiment on the global market. Better returns help to extend the number of microfinance investment funds with dual objectives by bringing financial returns to investors and achieving social development to draw more funds for investing in microfinance institutions.

However, low correlation of microfinance with mainstream capital market might change to high over time with the increasingly regulated MFIs integrating with the mainstream financial sector (Lützenkirchen et al., 2012). Correspondingly, a study by Brière & Szafarz (2011) on the impact of microfinance equity on a global diversification portfolio found that microfinance equity is closely correlated with the financial sector, and yields fewer diversification benefits, but is less risky than before.

3.9.2 Risks Profile

The microfinance industry has been growing over the last two decades, amid a changing market, product and services, distribution models, technologies, trends, and a broader context of risk profiles in the industry over time. Risk in microfinance is defined as future losses or declines in future income

(Fernando, 2007a). The potential consequences produce a negative impact on the MFIs (Steinwand, 2000). Risk can then be considered as the cost of poor management performance, capable of threatening financial growth and the long term sustainability of microfinance.

Some of the major risks in microfinance are uncontrollable, and derived from the external environment in which the MFI operates, including country risks, economic crises, war, natural disasters. The legal, institutional, and macroeconomic situations are differ between developed and developing countries, and also the affect on the investment objective of the funders. Risks arise from political instability, foreign exchange, interest rates, liquidity crunches, restrictions on the transfer of private capital or foreign investments, and low standards of financial reporting. Additionally, the ability of microborrowers in developing countries to repay the loans may be impaired by natural disasters or decreases in income due to depressed prices for local agricultural products; these risks could cause the real value of investment to be lessened. While the MFI cannot control these risks directly, there are many ways to prepare for such scenarios, and minimize the potential for negative impact. These external risks are only peripheral to the extent that MFIs are able to mitigate them (Steinwand, 2000).

Meanwhile, microfinance institutions face controllable internal risks, such as financial, operational, and strategic risks (see Figure 3.13). Most MFIs are concerned about financial risk, such as credit, liquidity, default and delinquency risks, which can be incurred when issuing loans to borrowers. Risk is heightened when institutions fail to follow successful models used in different regions. However, replication can cause loss if used without flexibilities or adaptation to the local operational environment, such as social and geographic contexts. In addition, credit risk can arise from the selection of a population with no ability to access business opportunities due to a lack of inputs, demand,

and/or market. It is useless to provide productive credit to such people without other inputs. Moreover, many MFIs confront an absence of supportive policy frameworks and daunting physical, social, and economic challenges, and shortage of skilled and innovative microfinance sector labor, resulting in a lack of appropriate operational and financial management to run the entity's operation (Ledgerwood, 1999). As result, some MFIs reach neither minimal scale nor efficiency necessary to cover costs, while some face liquidity problems due to mismanagement, diminishing their ability to adequately meet future cash needs.

An example of an institution experiencing losses is ACLEDA[32], which met a serious delinquency crisis in 2001. An increase in write-off of microloan portfolio from 4.02 to 10.20% in 11 mature branches over the previous year. In two of these branches, the Par value At Risk (PAR)$>$ 30 days and write-off rates exceeded 20%. Four branches accounted for 70% of the total delinquency in the microcredit portfolio. Bank Dagnang Ball[33] in Indonesia failed to comply with the regulatory requirements of the Central Bank. In 2004, they had serious liquidity problems due to bad management and poor government. At one time, NWTF[34] also faced a major liquidity risk because of insufficient demand projection. NWTF was not capable to meet the demand for loans due to inadequacy of funds, and had to ration credit and deal with discontented clients (Fernando, 2007a).

[32]ACLEDA (Association of Local Economic Development Agencies) is a non-government MFI in Cambodia, established in 1993. It became a specialized bank in August 2000 and a full-fledged commercial bank in December 2004, website: http://www.acledabank.com.kh

[33]April 8, 2004, Bank Indonesia formally withdrew the operating licenses of PT Bank Dagang Bali (BDB) and PT Bank Asiatic. Both banks are now in the process of liquidation after failing to meet minimal liquidity ratios and other requirements established by the Government, available at http://www.balidiscovery.com/messages/message.asp?Id=1860

[34]NWTF (Negro Women for Tomorrow Foundation) was a non-governmental organization, in Philippines. In 2005, NWTF started operating a microfinance thrift bank, the Dungganon Bank

Figure 3.13: Risk Categories in Microfinance

Financial Risks	**Operational Risks**	**Strategic Risks**
1. Credit Risk is the risk to earnings or capital due to borrowers' late and nonpayment of loan obligations. Credit risk includes: – Transaction Risk refers to the risk in individual loans. – Portfolio Risk refers to the risk inherent in the composition of the overall loan portfolio. 2. Liquidity Risk is the risk that an MFI cannot meet its obligations on time. 3. Market Risk includes interest rate risk, foreign currency risk, and investment portfolio risk. – Interest Rate Risk is the risk of financial loss from changes in market interest rates. – Foreign Exchange Risk is the potential for loss of earnings or capital resulting from fluctuations in currency values. MFIs most often experience this risk when they borrow or mobilize savings in foreign currency and lend in local currency. – Investment Portfolio Risk refers to longer-term investment decisions rather than short-term liquidity or cash management decisions.	1. Operational Transaction Risk (the document does not give a definition) – Human Resources Risk – Information and Technology Risk is the potential that inadequate technology and information systems will result in unexpected losses. 2. Fraud Risk is the risk of loss of earnings or capital as a result of intentional deception by an employee or client. 3. Regulatory and Legal Compliance Risk is the risk of loss resulting from noncompliance with the country's and law	**1.** Governance Risk is the risk of having an inadequate structure or body to make effective decisions

Source : Fernando Nimal, ¨ Managing Microfinance Risks: Some Observations and Suggestions¨, 2007

Besides the risks inherent to the nature of the microfinance sector, investors should be aware of the risk associated specifically with microfinance investment funds. Firstly, investors need to know that funds invested or lent to not-listed MFIs or sometimes non-regulated financial institutions and the holding instruments of investment funds, generally have no market price as they are not listed in the capital market, and is illiquid, so sometimes cannot not pay regular dividends or yields to investors (Dieckmann, 2007). Secondly, the investment might be exposed to foreign exchange risks depending on repayment agreements, whether risks are taken by MFIs (MFIs repay loans to funds in hard currency[35]), the funds (MFIs repay loans to fund in local currency[36], or both.

Barrès (2007) states *foreign exchange risk or currency risk* occurs when fluctuations in the currencies that dominate the assets and liabilities are not matched (either at the MFI level, the MFIF level, or both). The earnings of MFIs are subjected to volatility risk of exchange rate fluctuation when MFIs borrow in hard currency and lend to its clients in local currency, a mismatch in currency. Both investor and MFIs face with currency risk, if local currency is suddenly steeply depreciated against the investor's home country; investors lose while MFIs face huge losses or even bankruptcy (Abrams et al., 2007). The common method to address to this exposure is by currency hedging, including currency swaps, back-to-back loans, forward contracts, future contracts, and currency options (Bahtia, 2004). However, this hedging mechanism is not fully used in developing countries as it is costly, sometimes unavailable, and illiquid. This risk can also be reduced by diversifying currency across countries.

[35]"Foreign or hard currency" generally refer to USD or EUR. Wikipedia defines hard currency as currency that is regarded as an acceptable payment method in multiple countries, generally issued by developed countries that have a strong economy accompanied by a stable government, including UK Sterling (GBP), Euro (EUR), USD, Swiss franc (CHF), Japanese Yen, Canadian Dollar, Australian dollar, available at http://en.wikipedia.org/wiki/Hard$_c$*urrency*

[36]"Local currency" refers to currency other than hard currency, based on Barres, Isabelle, "The Management of Foreign Exchange Risk by Microfinance Institutions and Microfinance Investment Funds", 2007

Conversely, currency risks can be effectively hedged for European investors who invest in microfinance funds in Euro while most of the funds are dominated in US dollars, estimated at about 70% (Dieckmann, 2007).

In addition, further risks may emerge from rapid portfolio growth and the management challenges. MFIs may assumed growth when there is increase in demand and loan portfolio, but fund managers have put pressure on growth in some countries, including Georgia and Cambodia for example, due to concerns about the risk of overindebtedness of borrowers. Expanding the client set too rapidly potentially results in a loan portfolio of weaker quality, increases in Portfolio at Risk 30 (PAR>30), i.e the share of the portfolio for which payment are more than 30 days overdue, from 3% in 2007 to more than 5% in 2009, reflecting a problem of overlending (Lützenkirchen et al., 2012). Strong competition among all actors in microfinance not only promotes growth in MFIs but with it the risk of inability to repay loans to private investors, while decreasing the interest rates charged to the microborrower, impeding the capacity to generate profit.

Investment made in individual microfinance institutions is associated with the risk in management information systems which are inadequate or mismanagement through lack of monitoring, fraud, or failure to realize collateral (Biallas & Schwiete, 2006). The transformation of microfinance NGOs into regulated MFIs may also lead to operational risk when there are no appropriate management or governance systems; despite practical and regulatory requirements, well-equipped internal control systems are still limited in MFIs. In rare cases, transformation leads some MFIs to shift from low-income to higher-income clients, which may lead, eventually, to MFIs losing their currently targeted clients in order to directly compete with commercial banks in the domestic countries (Dieckmann, 2008).

As there is a sharp rise of competition within the microfinance industry for customer and financial resources, MFIs have developed a systematic approach to manage risk. This approach applies through the business line and activities, and is considered as a mechanism to prevent potential problems, reduce the scale of losses should they occur, to promote credibility in the marketplace, and capitalize on new opportunities for growth. It is important for MFIs to manage risk effectively, to build more confidence from stakeholders such as investors, donor, lenders, and borrowers, and to get more funds. Otherwise, MFIs may cease business when funds dry up and they are not able to achieve their social objectives of providing services to low-income people and poor (Steinwand, 2000).

However, risks are not inherently bad. Sometimes, Churchill & Coster (2001) says: in order to achieve desirable goals, it is necessary to take risks. A microfinance institution which has good risk calculation can accomplish its objectives by taking risks in lending money to borrowers, often without collateral, without credit histories, without business records.

The main instruments of risk mitigation are documentation, ensuring significant influence by the individual investor in the investee company, and special shareholder rights for development finance institutions (DFIs), training and retain sufficient staff to build institutional capacities and to ensure market saturation and acceptance. Risk can be mitigated through commercial structuring that requires involvement in corporate governance, which ties up substantial resources (Biallas & Schwiete, 2006).

3.10 Advantages of Investment in Microfinance Funds

Through the early to mid-1990s, microfinance investment funds have increasingly been used to channel funds to MFIs, and to support scaling-up the microfinance industry in developing countries and transition economies. Regardless of the different types of investment funds and the players involved, there are a number of benefits from continuing to use and expand MFIFs.

- ***Efficient diversification of investor's portfolios***: There is growing evidence that microfinance is more stable than, and uncorrelated with, the world market (international performance measures). In fact, funds continued to grow despite the global financial crisis that damaged most asset classes around the world in 2008. Assets of the top 10 microfinance funds increased by 32%, while emerging market funds sold off 20% (Reille & Mezieres, 2009). Microfinance investment may provide attractive opportunities for portfolio diversification since the risk adjusted returns exhibit low correlation with other asset classes. It is well suited to investors who seek a better risk return profile (Galema et al., 2011). In addition, Krauss & Walter (2008) states that MFIs may provide significant portfolio diversification value for international investors, although not for local investors, who have limited in-country risk diversification options. He found that microfinance investments expose a very low correlation with both global capital markets and the domestic economy[37]. MFIs Net Operating Income practically correlates to the domestic economy between 0.01 (GDP growth), to 0.02 (equity

[37] Based on study of Krauss & Walter (2008), MFIs are not detached from their respective domestic economies, apart from Net Operating Income, MFIs highly significant correlation with all parameters analyzed

market), and to global market between 0.03 and 0.07 (Novak, 2011). Similarly, Gonzalez (2007) argues microfinance portfolios have high resilience to macroeconomic shocks.

Moreover, portfolio investment in microfinance funds is better than funding alone to microfinance institutions, as investors and donors are able to diversify their risks by distributing their resources over broader and more different types of MFIs (Goodman, 2006), as investment will be spread between a large number of microfinance institutions in various countries and regions. High net worth, as well, can increase risk diversification into non-tradable investments like MFIs. MFIs could offer diversification benefits to investors, particularly private individuals and institutional investors aiming to spread their risk and reduce their portfolio volatility. In fact, a number of institutions such as BRAC and the Association for Social Advancement in Bangladesh, the SKS Microfinance and Spandana in India, and the Compartamos in Mexico have managed to sustain their growth rates without losing portfolio quality. Although MFIs in some countries suffered a serious setback during world financial crisis in 2008, the industry has been relatively stable in most countries (Fernando, 2007a).

- According to Goodman (2006), microfinance investment funds are an efficient tool to adapt for various dual return objectives, to harmonize donor and investor, to promote financial discipline, and to build a public-private partnership. Microfinance funds establish *flexible instruments* which can tailor a *wide range of social and financial objectives*. Investors increasingly consider investment in microfinance funds as a more efficient way to finance MFIs, and consequently achieve their objectives, because of the lighter management structure and more flexible regulations. Diverse financing instruments either in loans or capital financing promote different types of investors to actively participate in microfinance. For instance, funds target to commercial investors when they provide funding to mature MFIs, and support greenfield or start-up MFIs by targeting private donors or development agencies. Donor and investor can be coordinated to invest in a fund with clearly defined responsibilities and benefits to avoid conflict of interest, depending on their level of involvement in the fund.

Furthermore, microfinance investment funds can be a useful tool to spur on *public-private partnership*. Funds can leverage public funding by attracting private funds. Public institutions such as development agencies and donors contribute to the growth and financial sustainability of microfinance. Development agencies and donors can accept the first-lost tranche, provide technical support and track records, and even guarantee, which appeals and provides greater comfort for commercial investors to enter microfinance, and thereby a larger number of MFIs in the world are financed. Microfinance funds can be a bridge between this sector and traditional capital markets. Interestingly, investment funds can stimulate the greater *financial discipline* so that utilization of resources is more effective and will decrease the overall funding cost to MFIs.

- ***Short loan duration***: microcredits typically have short maturity, from six months to three years. This reduces the risk compared to credit with longer durations.

- ***Ethical return***: investment helps a large number of micro-entrepreneurs and their families to break out of poverty on their own merits.

MFIs are less correlated with global market and domestic economy for a number of reasons:

- *Risk management technique*: MFIs provide small sized loans on shortened maturity to a large client base, directly understand of their clients, use historical delinquency data and dynamic incentives. These are useful techniques to prevent default risk, as MFIs can take action promptly at an early stage where there is an increase in delinquencies, since loans are collected and monitored weekly, bi-weekly or monthly.

- *Client base operates in a safer sector*: MFIs clients tend to operate in the informal sector, less integrated into the formal sector economy, in areas such as food, clothes, fishing, beauty, etc, hence they seem less depend on import and currency fluctuation. Consequently their investment is in business activities that are less affected by world crises, and it is easier for MFIs for lending and loan repayment collection. Additionally, microloans represent only the resource for low-income entrepreneurs to continue and expand their businesses, not for a large part of whole population (Novak, 2011).

- *MFIs funding tends to have a longer maturity than their assets*: MFIs have a favorable duration mismatch which are able to attract line of credit from public agencies, DFIs, social investors. So their funding is long tenures. MFIs therefore, far relatively better than other financial institution in even economic recession, particularly for asset quality. So their funding is long tenures.

3.11 What is Investment Strategy?

Investment strategy can be defined as a set of principles, guidelines, procedures, documented to guide investors and fund manger to select and decide on their investments. The designation of strategy basically depends on the investor's risk-return tradeoff. For examples, some investors prefer to maximize return by investing in high risk assets, while other prefers low risk. So an investment strategy is a plan to maintain, realize, and invest available fund assets according to investment objectives and consistent with the investment selection criteria, risk and expected return adopted by the funds. It is recognized as a guideline and procedure for investment managers and all relevant parties, on how the money is to be invested, how investment decisions should be made, where and whom should be targeted, lists of financing instrument to be used, and so on.

Investment strategies should clearly document the extent to which funds are able to protect and minimize the risks that can occur from any potential events. All strategies, by definition, including investment strategies, have pre-defined goals and objectives, beginning with the statement of intent, and followed by other circumstances of the fund (which will be discussed later). The strategy of a private equity fund, for example, could be formulated as an effort to achieve superior economic return by focusing primarily on opportunities in the area of early stage venture capital (Schell, 1999).

3.11.1 Component of an Investment Strategy

The following is an example of information to be kept in mind when preparing and formulating an investment strategy. Funds should include and document these, and all other relevant factors considered, including reports obtained from professional advisers as integral components for the implementation of investment strategies.

- Fund objective, for example, financial return, social or both. Fund must ensure the asset allocation consistent with the fund's investment objective.
- Investment criteria; eligible partners, region of operation, beneficiaries, age of target group, and so on,
- Term and Key product; financing instruments,
- Reserving policy, fund may establish to help smooth a member's investment returns.
- Diversification; make sure the fund is exposed to sufficient diversification to diversify risk.
- Risk and Return; the fund needs to determine risk-sharing with the investor, the level of investment risk, and volatility of return regarding fund objective, and expected cash flow and liabilities.
- Hedging; think about the various type of hedging strategies to protect and minimize certain risks, i.e currency risk or investment risk.
- Insurance policies; often established to help and protect investees from loss.
- Leveraging or gearing; is the fund allowed to use leverage? If so, the fund investment strategy should clearly define leveraging policy. For instance, an investment strategy may specify the limitation of leverage ratio to be allowed, and the restriction of gearing via an installment warrant trust arrangement to certain types of assets.
- Liquidity and cash flow; ability of the fund to meet liabilities.
- Exit strategy.

3.11.2 Process of Investment Selection

The process of investing is a disciplined approach to build an investment portfolio. Investment process is systematically making decisions on any investment, assisting investment managers to correctly allocate assets by maintaining the consistency of its objectives. Different investors set different processes of investment according to their needs and preferences. A well-defined investment process, that describes how investments are made, can guide investors to focus and keep on track to make successive investment decisions, and to prevent investors from emotional investments which might fail and ruin the portfolio. With a clear investment process, investors can consult and go through each step and tick the boxes methodically.

In general, the investment selection process involves identifying, analyzing and selecting investees who likely to provide significant return. The process starts with screening and analyzing the target market, country, technology, legal and tax aspect of investment opportunity. It is an initial step to learn from each other (investor and investee) about their goals, activities, income needs, and constraints, to obtain mutual knowledge. An on-site visit is often made before making an investment decision, and after the selection of targeted investees, according to eligible criteria of the fund. Finally, if it is accepted, an investment agreement is reached and an investment is made. Ongoing reporting and monitoring are essential for the investor to know how well or poor the investee is performing, what problems arise, whether the results stay in line with the objectives set or not, and so on.

The selection process in microfinance investment is similar, involving searching and assessing investible microfinance service providers in the targeted regions facing the short and long term financial needs. This process is fairly simple and should focus on matching a fund's objectives with an institution's financing needs. The fund's asset manager is responsible for choosing the possible MFIs that a fund wants to invest in. The assessment of the relevant risks of the country where MFI is situated, in terms of its macroeconomic situation, regulation, tax and restrictions is usually one of a particular criteria that microfinance funds have to do in selecting investments. Besides, there are other various criteria that need to be examined to find the eligibility of an MFI for funding such as client structure, social and financial performance, MFI strategy, and management quality. The investment conditions are fundamentally evaluated with respect to the amount, tenor, structure and collateral of the funding offered (Dieckmann, 2007).

In conclusion, this chapter has reviewed the theories of microfinance investment funds and various components of its investment situation as it applies to the current issues in the microfinance sector. The particular characteristics of microfinance can be summarized in Figure: 3.14. It can be seen that while microfinance is characterized as an emerging investment opportunity for investors with a double bottom line objective, microfinance investment funds have progressively received attention from both investors and microfinance service providers. Microfinance investment funds are increasingly seen as a convenient tool to provide funding in a wide and diversified range of MFIs. Through such vehicles, investors in funds are able to reach a larger number of local institutions. In fact, it seems that more even the traditional providers of funding to microfinance, private donors and development agencies, are keen to contribute to the creation of such structures in order to attract additional providers of financial resources.

Whenever microfinance investment funds are structured appropriately, based on the target investors, there is no lack of financial resources. These funds expand the range of opportunities for financing microfinance institutions, enabling them to meet the required funding to increase loan portfolios on a greater scale. This will help them to diversity products and geographic focus, to bridge borrowers' demand gap, and to fulfill their social missions by expanding outreach to more unbankable individuals, micro entrepreneurs and small businesses. Evidences from many studies shows that microfinance funds are an efficient tool to diversify an investor's portfolio by financing with diverse financing instruments, to promote public-private partnership, and also with evidence of a low correlation to the global financial crisis, the returns will increase over time.

However, through this crucial review of the literature, comprehensive studies on investment conditions and the selection process of microfinance investment funds in selecting MFIs is not found. There is no detailed documentation or set of guidelines pertinent to these issues. Most studies have emphasized the performance of microfinance and microfinance investment funds, and mainly base their analysis on statistical techniques.

Figure 3.14: Summary Characteristics of Funds

Attractive Investment Proposition	**Sound Industry Fundamentals**	**High Social Impact**
- Market-base return - Defined exit strategy - Subordination option	- Encouraging growth potential - Historically low delinquency rates, solid profitability & increasing self-sustainability - Resiliency in periods of market turmoil	- Unbanked sector estimated at 1bn people - Funds will help strengthen the capital structure of MFIs is thereby helping to build indigenous financial system - Offers fully hedged funding to MFIs in locally demanded currencies

(*Source : Raimar Dieckmann, "Microfinance: An emerging investment opportunity"*, 2007)

Chapter 4

Research Methodology

This chapter attempts to overview the content analysis technique appropriate to the collected textual data and the objective of this research, with the aim of explaining the methodological process used to respond to the defined research question. This overview is broken into three main sections: Section: 4.1 examines and modifies the research question and sub-questions, a restatement of chapter: 1. Before proceeding to the real application of data analysis, it is important to understand the theoretical technique that applies in this research, and this is presented in section: 4.2, introducing the content analysis is, the practical uses and process. The final part, 4.3 explains in logical sequence the methodological procedures that were used to answer the research question, including data description, materials, and how categories were established and classified.

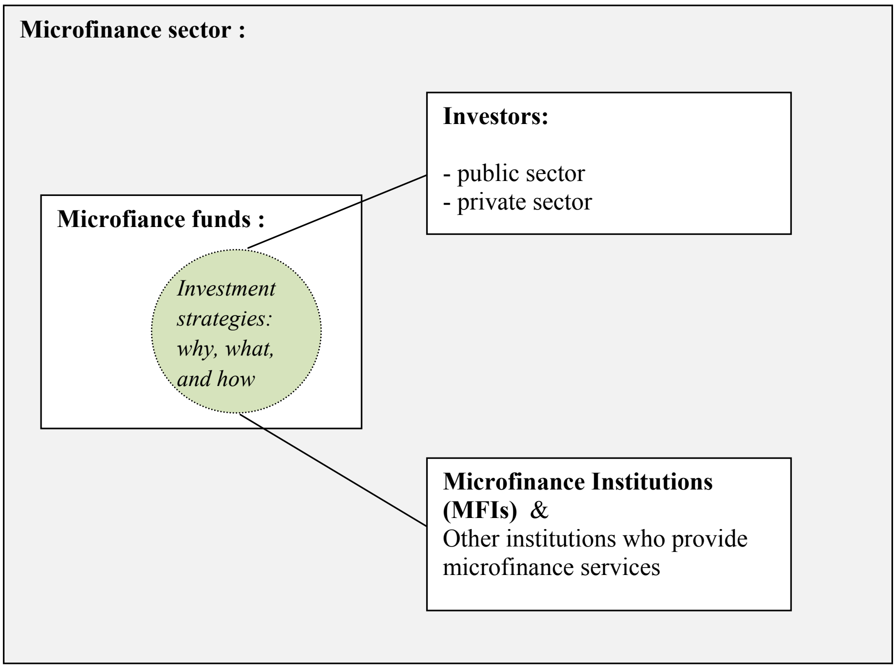
4.1 Formulation of Research Question

The research question and sub-questions set out in section: 1.4 were inaccurate and incomplete; more explicit formulations were only possible once the problem was clearly defined, after reviewing and understanding the context of microfinance and microfinance funds in Chapter: 2 and Chapter: 3 (see Figure: 4.1). Most previous studies have developed methods to investigate the performance of microfinance funds, mainly using statistical techniques, and rarely employing contextual information. There was no comprehensive study on the components of investment strategies, selection criteria, implementation processes and the perception that fund managers have of their microfinance investments. This research seeks to understand what kind of investment behavior information that microfinance funds want to communicate to investors and microfinance institutions. Hence the main research question is established: **"how are the investment strategies of microfinance investment funds designed?"**

To respond to this research questions a series of following sub-questions are formed and modified based on the existing literature and previous research, using a methodology with an emphasis on textual data.

1. For what purposes do microfinance funds make investment in microfinance?
2. What are the selection criteria for investment?
3. Who are the eligible partners?
4. What key products and terms are offered to microfinance institutions?
5. How do microfinance funds select financing from any eligible institutions?
6. What are the sources of funding for microfinance funds?
7. What is the geographic distribution of microfinance funds?
8. What risks and returns come from investments in microfinance?
9. Are hedging and exiting strategies discussed?, If so, what are they?
10. Are key products provided to any eligible partners in relation to their particular legal form or development stage?

Figure 4.1: Research Framework



The research question and sub-questions will be answered through a methodological and analytical approach. Since the purpose of this research is to reveal the investment behavior and perception of microfinance funds by investors and microfinance institutions through the information presented on the websites of each fund, a quantitative technique is not necessary. Qualitative content analysis is employed to disentangle the problem by investigating the textual data. Written information can be categorized systematically to answer the research sub-questions, statistical techniques can be used to analyze the occurrences of categories in answer to the last research sub-question. The proposed methods for analysis will be introduced in the next section.

4.2 Literature Review on Content Analysis

4.2.1 Definition of Content Analysis

The technique of content analysis was first developed in 1931 by Alfred R Lindesmith, Professor of Sociology at the University of Indiana, as a methodology to prove competing hypotheses, but became popular in 1960s when it appeared in an article by Glaser, "the Constant Comparative Method of Qualitative Analysis"[38]. Content analysis is defined differently from author to author, from time to time.

Content analysis is the most common form of document analysis. It is the process of organizing and integrating narrative qualitative information according to themes and concepts (Berg & Latin, 2004). Content analysis is a systematic research method that allows researcher to analyze textual information in a standardized fashion to make a judgment (Crowley & Delfico, 1996). In simple terms, it refers to the study of a subject through any type of communication to make inferences. Data is interpreted by objective and systematic identification of the specified characteristics of messages (Holsti, 1969, as cited in Stemler, 2001).

Krippendorff, 1980 (as cited in Elo & Kyngäs, 2008) defines content analysis as a research method for making replicable and valid inferences from data to their context, with the aim of gleaning knowledge, new insights, representations of facts, and practical guidance for action. The objective is to determine the concepts that concisely and extensively describe a phenomenon. Those concepts or categories usually build up a model, conceptual system, conceptual map or categories.

[38] according to Wikipedia website: http://en.wikipedia.org/wiki/Content$_{a}nalysis$

Content analysis is a scientific tool (Krippendorff, 2004), allowing researchers to interpret data in a scientific manner. Neuendorf (2002) defines it as "a methodology of summarizing, quantitative analysis of messages (written, recorded or printed communication) depends on the scientific method (with attention to objectivity, inter-subjectivity, a prior design, reliability, validity, generalizability, replicability, and hypothesis testing) and is not limited as to the types of variables that may be measured or the context in which the messages are created or presented. It describes rather than reports all details concerning a message set. This is consistent with the nomothetic approach to scientific investigations (i.e., seeking to generate generalizable conclusions), rather than the ideographic approach (i.e., focusing on a full and precise conclusion about a particular case)".

Content is generally divided into media content and audience content. Media content includes print media (newspapers, magazine articles, books, catalogs ,brochures, diaries, etc.,), other writing (web pages, advertisements, billboards, posters, graffiti), broadcast media (radio programs, news items, TV programs), other recording (photos, drawing, videos, films, music), live situations (speeches, interview, plays, concerts), observations (gestures, rooms, products in shops). Audience content comes from open-ended questions in surveys, interview transcripts, group discussions, letters to editors, postings to online discussion forums, listener responses on talkback radio, and so on[39].

[39]Refer to website of Audience Dialogue,Know Your Audience:Chapter 16, Content Analysis, http://www.audiencedialogue.net/kya16a.html

4.2.2 Practical Application of Content Analysis

Content analysis has a long history of use in research. In the 19th Century, content analysis was used to analyze hymns, newspapers, magazines, articles, advertisements and political speeches (Harwood Garry 2003, as cited in Elo & Kyngäs, 2008). Categories, lines, spaces provided, etc. were calculated manually until the development of more sophisticated research facilities, particularly computer based methods, which allowed content analysis to have an increased usage across many areas of study, including communications, education, health, journalism, sociology, psychology, and business (Elo & Kyngäs, 2008).

Modern technologies allow researchers to conduct content analysis on audience content (open ended questionnaires, video, audio, transcripts, etc.,) and media content to various depths of description and interpretation in easier and more efficient ways. Different organizations and different researchers apply content analysis techniques for different purposes. It is used to study recorded human communication, which is suitable for study on books, magazines, web pages, poems, newspaper, songs, paintings, speeches, letters, email messages, internet bulletin board postings, laws, and constitutions, as well as any components or collections of the above.

Content analysis is also used for quantitative and qualitative research methods (Graneheim & Lundman, 2004). One or both approaches can be used to identify content components such as words, phrases, theories, topics, concepts or other characteristics. Content can be used in media research, and was dominant at the beginning as a quantitative research method, with definitive categories derived from coding of textual information, then are described through statistic techniques (Hsieh & Shannon, 2005). Quantitative analysis, according to Kondracki et al. (2002), involves using the content of the message to determine "explicit themes, relative emphasis on various topics, amount of space or time devoted to certain topics, and numerous other dimensions". Qualitative analysis is often used to examine the latent or inferred meaning of the communication, which may lead to the development of constructions or theories based on the researchers' knowledge and evidence drawn from the study.

The technique of classification involves a search to identify an effective number of categories that present similar meanings within the discussion material (Moretti et al., 2011). The principal difference between qualitative and quantitative content analysis is interpretation over quantification, subjectivity over objectivity, flexibility in process over outcome, and concern for the influence of context on the research process (Kohbacher F., as cited in Holdford, 2008). Qualitative researchers put more effort on the themes, meanings and objectives of textual information than "numbers", concentrating on "latent" aspects of communication, while quantitative researcher rely on "manifest" aspects.

Content analysis can be applied to evaluate the effect (outcomes) and causes (inputs), to gain awareness, to increase efficiency of operation, to increase income, and so on. For example, Kothari et al. (2009), used content analysis to study the effect of selected disclosures by source-corporation, analysts, and business press on the cost of capital, stock return, volatility and forecast dispersion, which is an important tool to indicate a firm's risk. In addition, it is also useful for assessing trends in the activity of agents and patterns in documents. (Abeysekera & Guthrie, 2005), used content analysis to study the annual reports of a sample of 30 firms listed on the Colombo Stock Exchange to examine the two year trend of intellectual capital identification and codification and their patterns of intellectual capital reporting .

Meanwhile, content analysis provides an empirical basis for monitoring changes in public opinion. For example, to determine whether school missions statements shift after policy changes due to standard-based reform: data obtained from a study of mission statements in the late 1990s can be objectively compared to data collected at some point in the future. Similarly the technique can be a very practical tool to determine authorship by compiling a list of possible authors, examining their prior writings, and correlate the frequency of nouns or function words to help build a case for the probability of each persons's authorship of the data of interest (Stemler, 2001).

The technique of content analysis extends far beyond simple word frequency counts. Besides helping to summarize the formal content of written material, it can also describe the attitude or perception of the author of that material. For instance, by doing a content on transcripts of focus groups, it is possible to highlight dominant views and the reasons behind them, say to discuss the difficulty of the implementation of a student loan program. GAO evaluators can formulate a program's objectives by comparing a program's legislative objectives with those of the executive branches, summarizing its activities, and defining its results (Crowley & Delfico, 1996). As a research technique, content analysis provides new insights, increases a researcher's understanding of particular phenomena, and informs practical actions.

Content analysis provides users many benefits where it is used properly and correctly. However, since the technique works with large volumes of data, there are some problems that can appear such as incorrect coding system or poor classification, inappropriate records, especially due to the time and effort required to ensure reliability (Crowley & Delfico, 1996). In addition, a failure of content analysis might relate to faulty of development of categories, such as incorrect definitions and non-mutually exclusive and exhaustive categories (Stemler, 2001), the unclear or vague research questions, and excessive interpretation on the part of researcher (Elo & Kyngäs, 2008).

4.2.3 The Process of Content Analysis

Content analysis is a powerful, systematic, replicable technique to distil data (Weber, 1990 as cited in Crowley & Delfico, 1996). It involves developing categories and then counting the number of times they occur in a particular selection of text (D. Silverman, 2011). The researcher first collects a large amount of textual information, and the portions of text are broken down into units that can be numbered (McKEE, 2003). This technique involves in codifying qualitative and quantitative information into categories which can be predefined or defined at the time of data analysis, so that a pattern can be derived to present and report that information. This methodology allows the presentation of the published information in a systematic, objective and reliable manner.

The basic assumption in qualitative research is that content analysis relies on word frequency. In practice, the application of code and categorization of the data makes this technique more meaningful and reliable (Stemler, 2001). Approaches to content analysis will differ depending on what research questions a researcher is seeking to answer, the resources available (sources of data, people, technologies, etc.,) and the target audiences, those who need to use the information (Taylor-Powell & Renner, 2003).

Preparing the Data: First it must be determined whether or not the technique of content analysis is appropriate to be used for the research, based on the research objective, the nature of accessible data, and technical issues (Crowley & Delfico, 1996). In addition, selection of content analysis as a method depends on problems of research, availability of accurate recorded material, time constraints, and the kinds of comparisons sought. When starting the analysis, the researcher must also decide whether to analyze only the manifest content or the latent content as well. Latent content here refers to the inclusion of silence, sighs, laughter, or posture, for example (Elo & Kyngäs, 2008).

Researchers need to define what the relevant content material is, including the type and location of the sample. Decisions are to be made on sampling: whether to use probability or non-probability sampling is an important distinction when a document population is too large to be analyzed in its entirety (Crowley & Delfico, 1996). The sample must be universally representative of the total from which it is drawn (Duncan 1989, as cited in Elo & Kyngäs, 2008). Some factors can lead to a sampling result with biased data: subject of interest, selection of the means of research (i.e. newspaper versus television), time period (one month versus one year of data collection), and so on (Holdford, 2008). There should be a review of collected information to determine whether it meets the objectives of the analysis, and, as needed, an exploration of alternative sources of data where the content universe needs to be redefined or be expanded.

The researcher attempts, through learning and understanding the data, "what is going on". Bear in mind that when reading the data the questions are: who is telling, where is this happening, when did it happen, what is happening, and why. The aim is to become immersed in the data, so the written material is read through several times (Elo & Kyngäs, 2008). According to Krippendorff, 1980 (as cited in Stemler, 2001), five questions must be addressed in every conducting a content analysis: 1) what data is analyzed? 2) how is it defined?, 3) what is the population from which it is drawn?, 4) what are the boundaries of the analysis?, and 5) what is the target of the inferences?.

Research Question: Content analysis begins with research questions. Whether this technique is valuable depends on its capacity to explore the answerable questions by quantitative methods (Holdford, 2008). The determined research questions must be precise. If they are ambiguous or not suited to the users' needs, even a well-implemented method will produce findings of doubtful value. To be clear about the questions means to state them as specifically as possible so that the answers will be useful to decision makers (Crowley & Delfico, 1996). Meanwhile, Holdford (2008) suggests three common categories of question can be used to answer and to draw inferences.

Firstly, questions using who, what, how, when, and to whom. Secondly, the impact of the event or intervention on subsequent communication. Thirdly, the effect of the communication on some dependent variables. For example, what image of pharmacists are presented in pharmacy publications, or what influence does an pharmacy internet site influence have on the behavior drug consumers? The researcher needs to identify the key questions to be answered from the analysis, which properly respond to the research objectives. Three common core questions are: who says what to whom, why, how (via what channel), and with what effect? (Babbie, 2012). For a good analysis, the researcher has to read and re-read through the written material (text), or if the data is an audio or video recording, the researcher has to listen many times to get an understanding of the data, taking notes. These actions help to decide how to start working with the data as well as to begin defining content categories.

Unit of Analysis: Decisions must be made on how to record each unit of analysis - the portion of text to which a researcher applies a category label (Crowley & Delfico, 1996), and which is the best means of capturing the data (i.e. words, sentences, paragraphs, themes, phrases, whole text, ideas, etc.). It is necessary to choose units of analysis to study as content analysis relies on the frequency of the issues that are assumed to be important in the message ahead of those that are inconsequential (Holdford, 2008). Before coding, the messages have to be unitized; definition of each unit is necessary for the coding process and for comparing the results with other similar studies.

The unit of analysis can be a letter, the number of participants in a discussion, or the time used for discussion, depending on research question (Elo & Kyngäs, 2008). Themes are usually used as unit of analysis in qualitative content analysis rather than the linguistic (e.g. word, sentence, paragraph) which is for doing quantitative content analysis. In general, researchers need to search for a particular opinion or perception of interviewees or authors when using themes as a unit of coding, and this might be expressed in a single word, a phrase, a sentence, a paragraph or an entire document (Zhang & Wildemuth, 2009). Whereas, Holdford (2008) defines a unit of analysis as a segment of text that is comprehensible by itself and contains one idea, episode, or piece of information.

Coding: The process of content analysis consists of coding raw messages (i.e. textual material, visual images, illustrations) according to a classification scheme. Crowley & Delfico (1996) determines coding as "marking recording units of analysis with short alphanumeric codes that abbreviate the categories of variable and that carry other information as well". The essence of coding is bridging words into number for performing an analysis. The coding process is essentially one of organizing communication content in a manner that allows for easy identification, indexing or retrieval of content relevant to the research question. A coding manual should be developed as it serves an important role in guiding coding in a consistent way, including category names, definitions or rules of assigning code.

Codes can be defined before or during data analysis. They can derive from data, from theory or other relevant research findings, depending on the approach and aim of doing content analysis (Hsieh & Shannon, 2005; Zhang & Wildemuth, 2009). Where the coding categories are defined during data analysis (derived from raw data), to create ground theory by observation, this is known as "conventional content analysis". In contrast, "direct content analysis" is used to validate or extend a conceptual framework or existing theory in which code can be defined before and during data analysis, based on a theory or relevant research finding. Where the study starts with the counting of key words or manifest contents which are of interest to the researcher or by review of literature, striving to understand the contextual usage of words or content through inductive reasoning is known as "summative content analysis".

Categories: Creating categories, along with the actual coding of content information, is the most essential part of content analysis. The aim of developing categories is to assist in describing the phenomenon, to increase understanding, and to generate knowledge (Elo & Kyngäs, 2008). Categorizing the textual information depends upon a comprehension of what the category is. "A category is a group of words or phrases with similar meaning or connotations that occurred in the text which can be numerated based on explicit rules of coding" (Weber, 1990, as cited in Crowley & Delfico, 1996). When formulating categories, researchers have to decide which text fits into which category, and which things to put in the same category. This is the most difficult work in content analysis, however it can be assisted by the presence or absence of keywords. Example, if the story include words "Bush" then it fits into the category "American politicians" (McKEE, 2003).

Categories must be mutually exclusive and exhaustive. *Mutually exclusive* categories exist when no unit falls between two data points, and each unit is represented by only one data point. The requirement of *exhaustive categories* is met when the data language represents all recording units without exception (Crowley & Delfico, 1996). In qualitative analysis, the categorizing does not involve assigning numerical codes, as in quantitative analysis, where the label is an exclusive variable with preset code or values (Taylor-Powell & Renner, 2003). At the same time, a single unit of text can be coded into more than one category (Zhang & Wildemuth, 2009). A number of categories are introduced and selected, organizing them into coherent categories which summarize and bring meaning to the text, and then go through a series of texts to decide which one goes into which categories. It is essential to deeply understand the theoretical properties of each category. To minimize error, researchers can assign abbreviated codes and place them next to the text for a few letters, words or symbols, and have to be clear about what to include or exclude. Sub-categories might be identified and classified into each created category, while categorizing the data.

Table 4.1: Example of Categories and Subcategories

Question	Categories
What is the benefit of a youth mentoring program?	Benefits to Youth (Y)
	School performance (Y-SP)*
	Friendship (Y-Friends)*
	Self-concept (Y-SC)*
	Role modeling (Y-RM)*
	Benefits to mentor (M)
	Benefits to family (Fam)
	Benefits to community (Comm)

* Subcategories

(*Source: Ellen Taylor-Powell and Marcus Renner, "Analyzing Qualitative Data" , 2003*)

Before coding all the textual data, the coding scheme can be tested on a sample of text to confirm the consistency of category definition. Where possible, all texts are coded with regular checking of the coding. The basic analytic process is to count the occurrence of codes, whether all occurrences of a given category or only certain subcategories of occurrences. Drawing inferences from the frequency of codes is the simple and often most useful form of data analysis. Beyond simply counting, a researcher might look for an association between two or more variables. If data were to show the knowledge for one variable provides us with knowledge about the other, we would then say that the variables were associated (Crowley & Delfico, 1996). If data is organized into categories, identifying the patterns and connections within and between categories, the researcher may keep noting the important variations, and assessing the relevant significance of different themes (Taylor-Powell & Renner, 2003).

Analyzing, interpreting and reporting the results of findings: The researcher has to explain in detail the result of data finding: "what does it all mean?", and "what is really important?", using the themes and connections (Taylor-Powell & Renner, 2003). It is hard to know where or how to start to present the result of qualitative content analysis because data principally is subjective, interpretative, descriptive, holistic and copious. One should commence by looking at the themes and categories which have emerged (Hancock, 1998). Making sense of the themes or identified categories and their properties by exploring the attributes of categories, identifying the relationship between categories, uncovering patterns, and testing categories against the full range of data (Bradly, 1993, as cited in Zhang & Wildemuth, 2009).

The presentation of findings gives a description of the categories, i.e. the meaning of the categories, with further detail provided by subcategories (Elo & Kyngäs, 2008). For example, the category of "youth problems" would be identified and described through subcategories: education, drugs, mental health, sexual health, and so on. For emphasis, anecdotes and examples from the collected data can be used to illustrate points. The utility of *quotations* is recommended to justify conclusions, and to support the view of the reporter, by showing examples of what interviewees have talked about in the categories being described. A quotation can be extracted from a transcript of interview, messages of written media, and so on, to further report on the specified criteria and to clarify the situational contexts in which the criteria are applied (Hancock, 1998). Apart from quotations, matrices, graphs, charts and conceptual frameworks can be used, but the form and format of reporting depends on the research objective (Zhang & Wildemuth, 2009). Crowley & Delfico (1996) says statistical summaries and tables should be used to support verbal conclusions.

Statements about the statistical precision of the findings should be included, where applicable. Many researchers would agree that good content analysis is also quantitative, even though most content data is nominal; it can be coded, and counted for statistical summaries. Any exploration that results in either a number or a percentage is not content analysis, it is simply a subjective description of an observation (Holdford, 2008). A sufficient explanation of the result can help an audience to better understand the analysis method, its strengths and limitations (Crowley & Delfico, 1996). Research findings should be theoretically and practically based to confirm with evidence which can build, construct and validate criteria. Findings that are consistent with the literature, or vary theoretically in predictable ways, are more useful than results that have no link to past research (Holdford, 2008). However, this depends on the purpose of the research.

Before continuing with interpretation, reporting data and summarizing result, researchers need to verify their finding for *reliability* of results. Reliability of results can be increased through illustration of linkages between the data and the result. This is why researchers need to describe the analysis process in as much detail as possible when reporting the result (Elo & Kyngäs, 2008). Weber, 1990 (as cited in Crowley & Delfico, 1996) states that "to make valid inferences from the text, it is important that the classification procedure be reliable in the sense of being consistent: different people should code the same text in the same way". The validity, inter-coder reliability and intra-coder reliability have been subject to intense methodological research efforts over long years (Krippendorff, 2004).

There are several methods to *cross-validate*, including using related variables, or using a similar analysis method which checks on the reliability of the coding process, called "*cross-check preliminary result*", or in some circumstances, a researcher *applies statistical tests* to test the significance to rule out chance as an explanation for the results. Moreover, they can bring the content analysis result to compare other forms of evidence, either in the same evaluation or from the literature on the topic, a process called "*make external comparisons*" (Crowley & Delfico, 1996). The credibility of research finding also deals with how well the categories cover the data (Graneheim & Lundman, 2004). Finally, write up the correct results, and add the result summary and all documentation relevant to content analysis system design and application to the project working papers.

4.3 Research Design

4.3.1 Data Description

As the underlying technique of content analysis relates to summarizing and analyzing a large amount of textual information, in which many words of text can be classified into content categories, where each category consists of one or many similar words, then each word or phrase presence can be coded and counted. It is more than counting the frequency: content analysis can be used to describe the concept and character of the author or target correspondents of written material (i.e. brochure, message on website, annual report, leaflet, etc.,) to highlight the dominant views and the reasons for them.

Refering to this principle of content analysis and the previous review of literature on related topics, the objective of this research is to study on microfinance investment funds to provide knowledge, new insights and documentation as practical guideline for future action or study; these funds is seen as an emerging market where there are few prior studies, and the accessible quantitative data is insufficient to be studied; consequently, content analysis is appropriate for this research. More importantly, this research is seeking to understanding the attitude and perception of microfinance investment funds before investment into microfinance institutions, by studying textual information related to their investment strategies in order to find what criteria and tools are used for making investment in microfinance, how their investments are selected, what is expected from the investment, and so on. Textual information was collected from communications published on the websites of microfinance funds. The research questions are answered through the use of content analysis to analyze the available data, beginning with qualitative content analysis, then using the results for statistical description.

The sample selection is the group of firms classified as microfinance investment funds (MIVs) on the Microfinance Information Exchange (MIX)[40]. Among the 118 funds listed on MIX, there were 84 funds that could be accessed and from whom data could be gathered. The website address of each fund on this list provided convenient accessibility to read and collect the required information. This study employed secondary data obtained from the written messages posted on the websites that related to microfinance investment strategy. Funds present the written messages in different styles, some showing detail while others providing just a short summary or in some cases no information at all.

Amongst the listed funds, we found a number of large funds, such as ACCION, BlueOchard, Deutsche Bank, Incofin, responsAbility, Triodos, and NMI have established two or three more sub-funds with different investment structures but similar objectives, to further invest in microfinance sector. Where this occurred, those sub-funds were chosen for analysis rather than the main fund. However, the main funds were still used as information sources regarding investment criteria and investment selection processes, where they were not presented, or

[40]opcit. p..at http://www.mixmarket.org/funders.

insufficient at the sub-fund level. The relevant textual information on each fund's website was copied and saved in different files for analysis via computer software. The majority of the funds in the study are located in the United States and Switzerland (see Appendix A). Since the purpose of this research to explore the information about investment strategies that fund managers want to share to investors and MFIs, the size and the length of funds were not considered.

4.3.2 Methodology of Data Analysis

Data analysis began with detailed and repeated reading of all collected written information regarding the investment strategies of the 84 funds, aiming to immerse in data and to get a strong understanding of the content and meaning of the whole. When reading each text, the following questions arose: what being said?, what are funds doing, and why? what they are offering, and how?, and what is the audience?. While reading data initially, a table is created by hand to make notes of the key words or contents which frequently emerge from the messages, such as objective, equity, loan, shareholder, eligibility criteria, etc., This created a manual record to assist in determining the essential ideas or issues, especially keywords; it contained type of funds, whether investment criteria was outlined or not, the investment process, whether annual reports and fund brochures were available, and so on.

At the same time, consideration was given to how the emerging categories should be labeled, and whether coding in the text should be based on manifest or latent content, and what can be appropriately used to be the unit of analysis this studies (words, sentences, paragraphs or themes) by carefully examining the frequency of content or essential ideas in the data. Again, as there is no similar research studying on investment strategy in microfinance investment funds, the categories cannot be defined based on prior studies or theories, requiring a reading of the data word by word to allow categories to emerge.

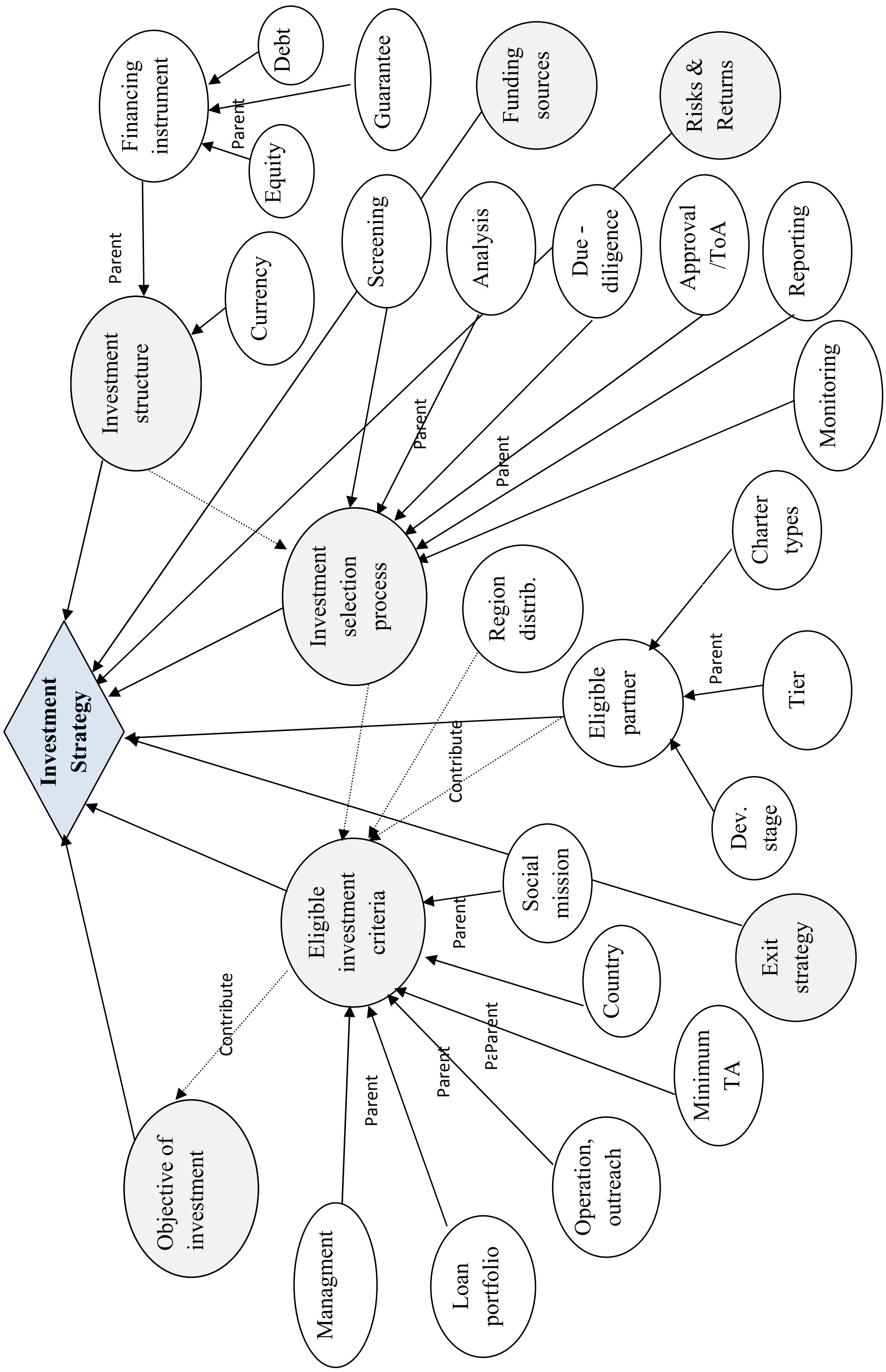
unit of analysis: Taking into consideration the first reading, the occurrences of a portion of text, the exploratory research questions of the study and its interest in perceptions, we decided to use *themes* as the unit of analysis. Themes could be expressed in a word, a sentence, a paragraph, a phrase or entire document. A theme is generally explained by category and its subcategory, so we further narrowed down the categories which were used to seek specific content, the expression of an idea, and the important issues arising. The classification of studied material into an persuasive set of categories is a technique of qualitative content analysis (Moretti et al., 2011).

Establishment of Category and Coding: Initially, categories in this study were derived from reading and highlighting the words or contents of the textual data that appear to capture the first impression, key thoughts or concepts, particularly ideas or concepts that we had not thought about. "Rather than using preconceived themes or categories, you read through the text and find the themes or issues that recur in the data; and these become your categories" (Hsieh & Shannon, 2005). From the classifications of keywords or concepts emerged a the categories which became the initial coding scheme to organize and group categories into meaningful clusters. Many sub-categories were created and combined into the fewer number of main categories.

The definition of each category and subcategory was given, based on the information from data and on prior studies or literature: an agreed set of categories to explain the themes. However, a few new themes arose during the analysis of data, so new categories were established, and the coding scheme modified. The coding scheme was initially created with many categories, and this eventually reduced to a list of only 12 categories (see Figure: 4.2) at the end of data analysis.

After listing the defined categories, all raw data was imported for coding using qualitative data analysis software called NVivo 8. NVivo helped to organize data, supported coding process, allowed the recalling of text based on categories or keywords, renaming or merging existing categories without disturbing other categories, automatic counting of the frequencies of categories or themes, and the creation of matrices for quantitative purposes.

Figure 4.2: Coding Model



The first phase of coding units of text into defined categories began with closely reading data line-by-line to correctly understand, and to categorize the keywords or sentences or phrases into the right categories. To avoid error, it was necessary to read again and again the name and the definition of each category before deciding to assign a chunk of text that represent a single theme into a specific category. For example, one subcategory of financial instruments was equity, which was coded through all sample data by a word (equity), a sentence (funds currently holding shares in microfinance institutions), a phrase (invests in equity instruments issued by MFIs and can also put in place safeguards through intermediaries).

At beginning, a text portion was coded to subcategory. There were no abbreviated codes in word or symbol applied to text for this data coding since the unit of text or keywords usually were highlighted and directly classified in each category. A unit of text could be assigned to more than one category at the same time. For example, a sentence extracted from a source of data "Advance SA has a double bottom line objective: contributing to economic development and poverty alleviation while offering a decent financial return to its shareholders" was coded to two different subcategories of a category: the objectives of the fund were 1) *economic development* and 2) *double bottom line*.

As coding proceeded, when there were new issues or contents that could not be assigned to any existing categories in the right manner, new ones were created, where the categories would be used for subsequent data. All categories and subcategories are created in the Tree Node which classifies them in various levels and criteria, represented in a tree diagram (see Table: 4.2). The tree diagram can be used to help in organizing categories into a hierarchical structure (Morse and Field, 1995 as cited in Hsieh & Shannon, 2005). Hence, most categories and themes in this study are identified from data on the basis of careful coding, classification and constant comparison. We looked for similar definitions from prior similar studies or theories as a guide for definitions and a checklist for emerging content.

Classifying the categories in the coding process was primarily based on manifest content - many themes were easily identified and was directly coded into a particular analytic category/variable, while others were more difficult to characterize because they were partially based on the latent content of the texts. The most thorny issue in content analysis is the decision on which text fits into which category (McKEE, 2003). To use the word equity as an example again, this was a straightforward subcategory: equity. Conversely, categorizing the currency an investment was made in was sometimes hard to define by type (foreign or local) as there was no information available. However, the latent content of the text could be used: for example, Indian fund IFMR was identified as financing only Indian institutions, so local currency was coded to this fund. The subcategory "other" was created during the coding to categorize any unit of texts which could not be attributed to existing categories or sub-categories, and for those that appeared only once in the message.

Table 4.2: Example of a Defined Category and Subcategories

Categories	Sub-sub categories		Sources
Investment structure			
	Financial Instrument		0
		Equity finance	53
		Guarantees	27
		Loans	68
		Others	26
	Currency used		0
		Hard currency	36
		Local Currency	35
	Maturity		28
	Size of investment		32
	Interest		9
	Collateral		10
	Date of payment		9
	Management Fees		8

(*Extracted from NVivo.8*)

At the completion of coding, all categories were rechecked one-by-one against the original full range of data. This led to some subcategories being merged into the main one where there was a high degree of similarity and complementarity. For example, at the beginning there were individual subcategories of poverty alleviation and economic development; acknowledging that poverty alleviation is one of the strategies of economic development, poverty alleviation was merged into the economic development subcategory. Some categories were merged when they were found to occur in less than three funds. The merging of two or three categories and subcategories did not disrupt the remainder, or lose information, as long as the same source of data was merged into one. In the end, there were 12 categories, with a few subcategories, to be described and interpreted in the reporting of data analysis (see Appendix B).

After verifying the category coding findings, the results provided an enumeration of frequency of each of the categories in the source of information (funds). Traditionally, content analysis has focused on the presence of variables or their frequencies and intensity, or identified by space or times (Crowley & Delfico, 1996). In this study, the number of times a category was described in all data sources was neglected in favor of the presence or absence of a particular category in each collected text. So frequency reporting was identified by the number of funds presented, for identified sub-categories, represented by "yes" or "no". The matrices tables were produced directly from NVivo. 8, which assisted in data reporting and interpreting the statistics. The purpose of this study was seeking to identify the most frequent occurrences, and the relationship between categories and themes, and accordingly the matrices tables were necessary. Most often the tables were exported to Excel, especially when analyzing the independence of two categories.

Reporting and Discussion: In reporting the correct research results by describing the wide range of defined categories and themes, and disclosing the pattens of important themes and the ideas of microfinance funds, it is then important to link the answer to the research questions. Describing and interpreting each category according to the research question was supplemented by an explanation of subcategories, which were coded from the raw data. Findings were reported and discussed simultaneously. We discussed what we found by comparing our results with the existing literature of related topics, and by using statistical descriptions of the results, findings can be counted and presented in simple tabulation of single variable and cross-tabulation analysis, to compare to previous similar studies. When interpreting the finding, quotations of units of text were excerpted from textual data to justify conclusions and supporting the expression of ideas.

Lastly, the categorical data was displayed in a contingency table which was used to identify the relationship between categories or between category and subcategories. Chi-square (χ^2) technique was used to monitor, to find out and to verify those assumptions. The process of content analysis in this study involved identifying themes and categories which appeared on the textual information of sample funds, coding for counting the occurrences of those categories, interpreting qualitative data, interpreting from result findings, and attempting to discuss, verify, confirm and qualify them with the prior research through data findings.

Figure 4.3: Summary the Steps in Data Analysis in this Research

Steps	**Examples**
1. Reading and highlighting word, sentences, phrase ⇩	We aim to improve access to affordable financial services for millions of families in order to contribute to poverty alleviation and sustainable development.
2. Key words/ concept/content setting up ⇩	- Affordable financial services - Poverty alleviation - Sustainable development
3. Primary categories setting up with its definition ⇩	Category: objective
4. Coding proceeding (*by using computer software)* ⇩	Straightforward to each sub-category: - Affordable financial service - Poverty alleviation - Sustainable development *(New themes or categories might be developed with their definitions, e.g. Diversification)*
5. Organized agreed group of categories: some categories or sub-categories with similar meaning were merged ⇩	Category: Objective Sub-categories: - Affordable financial - Economic development - Diversification *(Poverty alleviation was merged into sustainable development)*
6. Double check and verification ⇩	- Recheck the report of each category against full range of data.
7. Reporting finding and discussion	- Describing each category which was often explained by subcategory (quotation was used to justify idea) - Descriptive statistic: was used to show the frequency of each category, its relationship and for comparing with prior similar studies.

Chapter 5

Finding and Discussion

After the review of relevant literature on microfinance and microfinance investment funds studied in chapter: 2, 3, and the analysis of collected data in chapter: 4, this chapter presents the findings from our data analysis and a discussion. We discuss alongside our findings by observing and comparing our work with previous studies or theories where available. This chapter is organized into three main sections: data finding and discussion; statistical testing of categories; and a summary of significant findings. The first section 5.1 is a long and descriptive section in which the answers of all sub-research questions are presented and examined. The reasons why microfinance investment funds invest in microfinance is shown in sub-section: 5.1.1, the criteria that microfinance funds set as guidance in selecting investment is set out in sub-section: 5.1.2, the eligible partners is talked about in sub-section: 5.1.3, the key products and their terms being offered to MFIs is in sub-section: 5.1.4, the process of investment selection is discussed in sub-section: 5.1.5, the funding sources of microfinance funds which influence the type of investors is addressed in sub-section:5.1.6, the regions that microfinance funds provide financial access to is in sub-section: 5.1.7, the characteristics of risk and return from such investments is discussed in sub-section: 5.1.8, and exit strategies, hedging and leverage are briefly introduced in sub-section: 5.1.9. The results of our data analysis can produce categorical data, enabling us to test bi- categories to see their relationship, and this is presented in the second section: 5.2. The chapter concludes with a summary of significant findings in section: 5.3.

5.1 Data Finding and Discussion

5.1.1 The Main Objectives of Investment

In general, objective refers to a specific result that a person or an entity aims to achieve within a time frame and available resources. The objective of a business may include making a profit, expanding internationally, or minimizing expenses. In an organization, the investment objective is a crucial part of the investment strategy, detailing what you want to accomplish from your investment in a specific period, and so on. It usually answers the questions: what is the financing goal?, for how long will it be funding?, how much does it cost every year? Since the purpose of this study is to examine on the investment strategies of microfinance investment funds, it is essential to understand their objectives in investing in microfinance.

Many purposes were presented by the sample funds. As can be seen in Table: 5.1, among the 84 funds: 42% seek a contribution to economic development by focusing on poverty alleviation (n=35); for 36% it was the provision of affordable financial services to ultimate beneficiaries (microfinance clients); 35% were vehicles to flow capital to MFIs (intermediaries between MFIs and final investors); 31% had a double bottom line objective (financial and social return), 23% attempted to support MFIs for growth, 8% sought to forge partnerships with MFIs and investors, and 7% had a triple bottom line objective (financial, social and environmental return), or sought the diversification of financial products and geographic focus. The category Others included the expansion of portfolio investments, and the combination of technical and financial partnerships. Similarly, economic development is identified as a major response, represented by 21% (the presence of economic development in 35 out of 164 codings to the objective category). Clearly, four reasons are dominant: poverty reduction, affordable financial service, intermediaries and double bottom line objective.

Table 5.1: Objectives of Investment

Objective	Frequency	% of funds	% of frequency
Economic development	35	42%	21%
Double bottom line	26	31%	16%
Triple bottom line	6	7%	4%
Affordable financial service	30	36%	18%
Vehicle to flow capital to MFIs	29	35%	18%
Others	6	7%	4%
Improve MFIs for growth	19	23%	12%
Diversification	6	7%	4%
Forge partnership	7	8%	4%
	164	195%	100%

Economic Development

One of intentions of microfinance funds investing in MFIs is to support to the objectives of MFIs, aiming to alleviate poverty. As it is well known that "microfinance enables poor people to protect, diversify, and increase their income, the essential path out of poverty and hunger" (Littlefield et al., 2003), by providing financial services i.e. microcredit, with technical support, MFIs seek to raise the living standards of the poorest of the poor, and poor households in remote or deprived areas, who need capital to start or expand their own small business. Loans are available for both financial and non-financial purposes, depending on the type and objective of the MFI. Microborrowers can borrow for income generating purposes, and also for health and education. MFIs prevent their clients from going into more in-debt with a loan shark, who often charge very high interest. A wide range of MFIs is a proven, market-based solution to cope with the instabilities of lives and inequalities in society, so investment in microfinance is considered to be an effective tool in poverty alleviation, as the poor can increase their income, improve their welfare, achieve empowerment for women, and reduce the gap between the poorest and wealthiest people.

> *The objective of NMI is to contribute to the empowerment of poor people and to the creation of jobs, wealth and economic social sustainability in developing countries by investing in MFIs.*

> *We support organizations that create economic opportunity for the base of the pyramid through access to capital. We invest in organizations that provide access to financial services, business opportunities, and property rights that are available to most citizens of developed countries and are key to building wealth. Our objective is to promote economic advancement worldwide. (Omidya)*

Funds further presented that investment in microfinance is perhaps one of the solutions to help micro and small enterprises (SMEs) and low-income entrepreneurs who suffer from a range of capital problems for their business establishments and developments, while formal financial institutions reject loan applications due to an absence of collateral or credit history. Since microfinance funds believe that MFIs can potentially reach a large number of clients, they finance or create a new MFI where needed to continue or extend lending to those groups. Some funds also provide technical support to help MFIs diversify their funding sources, i.e from the capital market, to become financially sustainable. SMEs in developed countries are particularly considered as the backbone of the local economies, contributing to income generation and employment creation for economic growth; this is a key reason why funds want to promote the integration of more SMEs or small enterprises into formal systems. These group ultimately offer jobs to the poorest in local communities to earn higher revenue, reduce vulnerability, and create income stability.

Through investing in MFI, microfinance funds expect to reduce levels of poverty as a payoff from economic development in developing countries. Funds aim to promote inclusive economic growth by investing in any MFIs or institutions which deliver the fundamental financial services to people living in poverty through reducing unemployment, increase equality and general welfare in the society, especially the financial stability that borrowers generate from micro-loans.

> *Seed Capital Development Fund is dedicated to economic development through the creation of mechanisms that link microfinance institutions to capital markets and contribute to the growth of a sustainable microfinance industry. We are convinced that the success of small enterprises is the most effective and dignified way of reducing poverty and aim to support low-income entrepreneurs by expanding the financial services available to them. (SCDF)*

Double-Bottom Line

Funds introduce an investment in microfinance that can offer investors, especially socially responsible investors, a dual return: to maximize both financial and social value. Microfinance is seen as a strong development tool that creates simultaneously a satisfactory social and financial return to its investors. It is an attractive asset class that provides a competitive financial return, low potential risk, appreciable diversification value, and positive social return to its investors. Beyond the contribution in economic development (as discussed above), microfinance funds seek for an acceptable financial return from investment to their investors.

Funds viewed microfinance as a hybrid model in which both social and financial aspects are integrated in order to achieve their objectives. Funds seemed to be looking to work with MFIs where there is a potential to grow and maximize their social impact, as this will most effectively translate into superior financial returns for MFI shareholders through strong growth and sustainability. The growth of microfinance results in scaled-up operations, decreased transaction costs, reduced interest rates on borrowers, and increased favorable social impact, that appeals to more social-minded investors who also see it is profitable at the same time. In this framework, funds provide capital (input) to MFIs who provide small loans (output) to microborrowers. This type of capital from microfinance funds will create an outcome (financial and social benefits) to all stakeholders. Hence funds seek for both a financial return and a social impact from investment in microfinance.

> *Advans SA has a double bottom line objective: contributing to economic development and poverty alleviation while offering a decent financial return to its shareholders.*

> *The fund has a double bottom line strategy, on the one hand maximizing its risk return profile for the benefit of the investor, and on the other hand maximizing the social outreach in breadth and depth to micro, small and medium enterprises in emerging and least developed economies (Dual Return Fund)*

Triple-Bottom Line

Where the double bottom line objective is augmented with an environmental component, for example some funds such as Africap, Hivo Triodos Fund, I&P Development, and IFI Fund, this is known as triple bottom line. They consider microfinance as a solid business running on environment and social aspects along with a financial gain. Environmental issues are increasingly important for all businesses and should be integrated into real practice, and inform the choices of some MFIs in giving loans for business formation. MFIs should create regulations and make crucial efforts to address to environmental responsibility and impact. It is essential to increase environmental awareness among MFI clients and staff to avoid adverse impact on the planet as well as society.

However, triple bottom line is less represented than double bottom line in this study. Some MFIs have started taking more consideration and extending into triple bottom line objectives where there is concern about the convergence microfinance and mainstream social performance framework, that may weaken the relative position of poverty outreach/impact in the sector, leading MFIs to withdraw from being held accountable for a poverty reduction focus. More importantly, a negative impact of environmental practice can effect the profitability of MFIs once the natural resources become scarce and expensive for MFI clients. At the same time, the health of MFI clients may be worse due to disadvantageous environmental situations, which may have a negative impact on productivity and lead to a decreasing ability to repay loans or save (Hall et al., 2008). A study by Symbiotics (2011) found a significant number of microfinance funds adopting a new triple bottom line approach in their funding policies, counting as many as 45% of interviewed MIVs that have taken environmental issues into account for investment decision making. Microfinance funds can attempt to maximize value creation from investment in microfinance while generating significant environmental, social performance and capital appreciation.

> *AfriCap invests with a triple bottom line objective focusing on, social, environmental and financial returns (AfriCap)*

> *As a responsible member of the microfinance industry, the Advans group does not only consider the economic impact of its operations but also takes into account the specific social and environmental issues prevailing when dealing with MSMEs in developing and emerging countries (Advance SA)*

Affordable Financial Services to Beneficiaries

Another objective of investment in microfinance is to supply affordable financial services to ultimate beneficiaries, including poor and low-income households, SMEs who faced some constraints in accessing capital or other financial products and services to start or expand their business. Those constraints include collateral requirements, high interest rates, the unavailability of services in the region, insufficient capital and so on. Microfinance funds see that investing in MFIs can strengthen and support these MFIs to meet the current demand of their clients, to expand affordable price lending into new areas where credit was charged at very high interest or was not previously available, and to provide additional innovative services such as education and medical care for families of borrowers and the communities they serve. The enhancement of availability and feasibility of a broader range of financial services provided by invested institutions, such as credit, savings, insurance, payment, remittance and others at well-timed and affordable prices empower and equip the poor, low-income households to extend income generating opportunities and act as a buffer for sudden emergencies, business risks, and therefore is one of benefits that investment funds wish for.

> *Aavishkaar Goodwell aims to improve access to affordable financial services for millions of families in the base of the pyramid in order to contribute to poverty alleviation and sustainable development*

> *We aim to improve access to financial services for the world's poor by contributing to the growth and reinforcement of the microfinance sector (Oxfam-Triple Jump).*

Vehicle to Flow Capital to MFIs

Microfinance funds showed that the root of the prevailing problem of MFIs in extending micro-loans to more clients is the insufficiency of existing funding to finance the constant growth of institutions, and to meet the increase of their clients' demands. The global expansion of microfinance generated an unprecedented financial resource gap in which the largest MFIs received the bulk of financial resources. As a result, the small and innovative MFIs with less technical capacity and/or limited accesses of funding were working with marginalized and rural populations, and being increasingly ignored. Funds acted as financial intermediaries for MFIs and final investors by mobilizing capital from various types of investors and refinancing those capitals to MFIs for scaling up their outreach. The outreach could be made either by innovating products available or enlarging geographic focus. This capital would be also used to strengthen MFI performance, and secure and attract additional funding.

Microfinance funds seemed believe that the increased financial resources from their investments are a long term source which complement the existing financing initiatives in the region. Moreover, funds not only seek to leverage the capital from commercial sources to MFIs but also aid them to attain the additional financing from senior funding through the current investment capital, through which MFIs ultimately can reach financial sustainability and no longer depend on grants or donations. This presentation is in accordance with the previous studies that define a microfinance investment fund is beneficial tool to financing collectively in a wide and diversified type of MFIs. Microfinance funds have different legal forms, diverse structures that serve the same purpose: "they channel the increasing source of funding to micro-entrepreneurs via MFIs established in developing countries" (Goodman, 2006). To fully meet the high demand over the long run, microfinance institutions require more funding, around $275 billion (Dieckmann, 2007), has to be found through more alternative sources of funding, particularly from commercial sources. In this case, microfinance investment funds are seen as as new market for microfinance, emerging with the aim of channeling the collected funding from investors to finance the required funding, and for the growth of microfinance sector.

> *The Dignity Fund aims to increase the number of poor households with access to credit, savings and other financial services by providing debt financing to promising microfinance institutions. The Dignity Fund believes that additional funding will enable microfinance institutions that are seeking capital for growth to reach more poor clients, allowing more entrepreneurs to lift themselves out of poverty with dignity.*

> *the PlaNet MicroFund has three main objectives: 1) To help increase the number of clients and the size of the loan portfolio of MFIs by granting them loans designated for on-lending. 2) To accompany institutions progressing from dependence on start-up*

> *grants to financial autonomy by providing them with loans up to three times. 3) To encourage institutions to look for other lenders or investors, as a way of achieving financial sustainability.*

To Grow MFIs

Microfinance funds hope for the growth of MFIs from their investments. Funds strongly believed that those MFIs would be able to build up their capacities, expand their outreach to all microfinance fields, increase market penetrations, extend into new markets, and innovate and develop new products and services for increasing profitability. Funds also contributed in the formulation and improvement of the organizational structure and performance of invested MFIs by actively managing, monitoring and closely working with investors, microfinance networks and technical assistance providers. In addition, funds would create and maintain a long-term relationship with MFIs which are talented and have the growth potential to further supply commercial funding; and/or funds could accompany those institutions to look for other potential investors. So financing, along with the participation of microfinance funds in MFIs, is an attempt to enhance efficiency and advance those MFIs to a new level of institutional sustainability, scalability, professionalism, and/or transform themselves into regulated institutions. Theoretically, the development of MFIs should provide more opportunities for investors to finance MFIs for financial return and social impact.

> *We aim to grow MFIs at best practice, with tight financial discipline, pro-active risk management and an innovative approach that emphasis social returns to create financially healthy institutions (Agora).*

> *Microfinance Enhancement Facility (MEF) has been designed to support the growth of microfinance institutions. objective is to ensure that microfinance continues to stimulate growth (BlueOchard-Microfinance Enhancement Facility)*

Other

Other purposes that microfinance funds presented on their websites, included diversification of financing instruments and portfolio, and acting as an active investor to forge partnership with MFIs and investors. A minority of funds talked about investment expansion into new regions where funding was unattainable previously, and where there is potential for shareholder return by introducing their existing financing instruments, either in capital investment or loan lending. Microfinance funds could create and innovate a new adoptable and accessible fund in those regions if needed. Funds could diversify their investment portfolio through the innovation of financing instruments, a flexible and convenient approach in a large and diversified range of MFIs in various regions over the world. Portfolio diversification is seen as a method of resource sharing and cross-country co-operation within the network. It might also provide a greater stability and efficiency of employed resources than investment in a single MFI. In addition, an inclusion of microfinance assets possibly benefited to reduce volatility of funds' portfolio because microfinance is recognized as new asset class which has a low correlation with global market fluctuations.

Furthermore, funds intend to create longlasting partnerships, keep good relationships among stakeholders, whilst looking for return on investment. As already discussed, microfinance funds want to build a longstanding relationships with competent MFIs because it is a good avenue for both funds and MFIs.

MFIs could have more additional funds for sustaining their outreach and growth, while funds were able to get a reasonable return for their development and for shareholders. A relationship could be established over a first loan which could evolve into a second loan, and/or a capital investment. This depends on the prior approval and performance of invested MFIs which comply with investment agreements and business ethic and principles.

> *Its objectives include catalyzing the formation of equity vehicles for products and services related to ACCION's core mission, leveraging ACCION's capital to expand our geographic reach, and contributing to ACCION's goal of supporting emerging social investment fund managers. (ACCION-Gateway Fund)*

> *The goal for DID is not just to improve access to financial services for the largest number of individuals, but to make a diversified range of financial services available also.*

> *Aim is to build long term relationships, based on transparency and fairness, and a shared commitment to relieving poverty and caring for the planet (Triodos).*

In sum, the objectives of microfinance funds in investment in microfinance were found to be broad, however, the most frequent ones were contributing to economic development (a poverty alleviation focus), affordable financial services, channeling capital to MFIs, and a double bottom line objective. These reasons were linkable and interchangeable. Microfinance funds can promote economic growth through microfinance. Indeed, funds can promote poverty reduction in developing countries through collecting capital and refinancing in MFIs with existing financing instruments, or by diversifying those instruments and tailoring to the need of MFIs. The accessibility of the required additional funding allowed MFIs to provide affordable financial services in breadth and depth of outreach, including the poorest, poor, unbankable, low-income households and SMEs. In turn, funds definitely receive a reasonable financial return, and/or even are able to significantly benefit from their diversification of portfolio investment, once MFIs become well-developed and profitable.

From this explanation we can say that most microfinance funds strive for a dual return (earning for an investor while achieving social benefits) from their investment in MFIs, through providing benefit to MFI clients to earn living for themselves, while receiving interest on loan lending or adding value in capital invested. A few funds have begun seeking a triple-bottom line return (financial, social and environmental value). An interesting parallel can be seen in the objectives of microfinance investment funds and MFIs: the object for both is a positive social impact and a financial return, and there is a possible concurrence of development of MFIs and microfinance funds.

5.1.2 The Investment Eligible Selection Criteria

Investment selection criteria is an essential components of the investment strategy of microfinance funds. It is an internal policy that provides guidance to fund managers for choosing investment in microfinance. This policy significantly varies from fund to fund, depending on investment philosophy and strategy. It is necessary to determine and establish a set of criteria that conform to the investment objective because it can help fund managers to make correct and productive decisions. The investment eligible criteria of each microfinance fund as elaborated on fund websites was studied to answer to the second sub-question of this research.

As Table: 5.2 shows, there are a number of eligible investment criteria that microfinance funds required MFIs to meet. Among those criteria, the loan portfolio and financial quality was the largest, accounting for 36% of studied funds, followed by social mission criteria (32%), management quality (27%), operational and outreach quality (26%), country context and legal status (12%), age of the MFI's operation (12%), minimum total assets or capital (8%), and only Dutch MicroFund required a match with the fund's investor interests and objectives. Loan portfolio and financial quality also accounted for 23% of total responses (30 out of 130) of the eligible criteria. Institutional qualities (financial, management, operation and outreach) and social mission criteria appeared more frequently.

Table 5.2: Eligible Investment Selection Criteria

Eligible Criteria	Frequency	% of funds	% of frequency
Age of MFI operation	10	12%	8%
Minimum total asset	7	8%	5%
Country context and legal status	10	12%	8%
Management quality	23	27%	18%
Operation and outreach	22	26%	17%
Loan portfolio and Financial quality	30	36%	23%
Social mission criteria	27	32%	21%
Investors'interest	1	1%	1%
	130	153%	100%

Age of MFI's Operation

The age of operation in this study referred to the length of time that an institution had provided microfinance services. Only 10 funds mentioned about the age of institution as one of selection criteria; of those 10, five funds preferred a finance institution which had operated at least three years, three funds required at least two years, and the rest targeted start-ups, with at least one year of operation. In practice, since the different funds have distinct objectives to invest in various types of MFIs, the historic time of operation presumably reflects the development stage of MFIs, from start-up to maturity, as well as the efficiency level. As Masood & Ahmad (2010) says "the age of microfinance institutions is a positive determinant of the efficiency level but size does not much matter". So the age of operation is one of eligible criteria. However, we found less than one third of funds mentioned anything about length of an MFI's operation. This finding showed such criterion seemingly is not important to mention or to inform to stakeholders, contrasting to a previous study that considered the age was essential to determine the level and the type of institution.

Minimum Total Asset/Capital

Seven microfinance investment funds mentioned the necessity of an minimum existing total assets (TA) or capital as one of their investment criteria (some funds focused on total asset while others focused on capital). Out of the seven, six funds required the equivalent total assets in a few million dollars or even less, between US$50,000 and US$2,000,000. US$10,000,000 was required by large funds, BlueOchard and REGMIFA. Only Frontier Fund preferred the eligible institutions which had capital at least KGS 1,000,000.

TA/capital requirements vary from fund to fund as well as from development stage of MFIs. A fund can finance a wide range of MFIs by reducing the minimum TA, relying on the size of the institution, location (domestic or international institution) or the financing instrument that the institution employs for fund raising. For example, " *REGMIFA defined their partner lending institutions (PLIs) by their current total asset: The small PLIs are those with total assets below US$10 million, the medium PLIs have total assets* *between US$10 million and US$30 million, and the large PLIs have total assets in excess of US$30 million*". The occurrence of this requirement was very few. We can assume similarly to the age of MFIs' operation criterion that funds regarded as insignificant portion to disclose on website. However, the total asset is an elementary for classifying the MFIs into tiers as discussed in section: 2.3.1 which can acquaint investors, funds, and MFIs with the type of MFIs that investment funds prefer to finance (as in the example of REGMIFA). Additionally, the net worth of this required asset/capital is treated as a basic alternative source of loan repayment to funds in case MFIs have negative cash flows, are faced with insolvency, or if institutions want to get loans over several times.

Country Context and Legal Status

Only ten funds mentioned the country context and legal status as their investment criteria. Country context includes political, economic, legal, financial structures, restrictions, and incentives (including taxation). The legal form of institutions refers to the type of microfinance service providers, such as regulated MFIs, NGOs, banks, cooperatives, and others (discussed further in section: 5.1.3). Funds examine the operation of identified MFIs, whether or not they comply with local laws and the regulations set by the central bank, credit regulatory or supervisory body, and what if any restrictions there are on resource mobilization, potential competition. Among these funds, the majority targeted investment in developing countries where there was less access from other international funds and where the potential losses may happen.

The location of MFI appears to be a predominant factor for performance, as the impact of domestic macroeconomics may result in an increase or decrease in the number of microfinance investment funds that attempt to operate in a country, and the MFI's performance is associated with overall economic performance. When macroeconomic growth is higher, MFIs are able to improve financial performance due to the lower default rates and operating costs. Previous studies on whether and how MFI succeed noticed a dependency on country context, and concluded that microeconomics and the micro-institutional environment where MFI is located, have a significant impact on success rates (Ahlin et al., 2011). So the criterion country context and legal forms should be included in the eligible criteria for investment selection. However, it was not displayed as significant as a context in this study, especially under the investment criteria of microfinance funds.

> *The underlying investments of the fund are mainly in transition or developing countries. These countries can be subject to political risks, economic unstable and poorly developed financial infrastructure. Through in-depth country research and comparison, Dutch Microfund selects the most promising investment opportunities (Dutch-Microfund)*

Social Mission

As already discussed, the objectives of microfinance funds in investment in microfinance in the previous section: 5.1.1 funds also aimed for social return from their investments. Out of the 84 funds, 27 included social mission as one of their selection criteria. Funds stated that qualified MFIs might have a coherent social mission and objective, with a commitment to fighting poverty in their societies through loan lending and creating income sources for poor, low-income household, and vulnerable groups, particularly women, in any areas (rural or urban) to improve their lives. It was also well suited to any MFIs, businesses, and projects working with environmental issues such as forest protection or animal welfare. Funds further required that a MFI have to develop a mechanism or system to evaluate the results of social performance from what they had done, and to see whether MFIs were achieving the social goals which had been set out in their mission. Furthermore, some funds looked deeper into the historical data to determine the actual percentage of social performance impact on the society. For example, the total number of clients in terms of gender, income level, and purpose of loan (health care, agriculture, etc.).

Funds may also have to list what should be included in their social mission, which can be used as a guide in identifying whether MFIs meet this criteria. A set of social mission guidelines can also support microfinance fund managers in choosing MFIs oriented towards particular social return to funds as well as to socially responsible investors. Most funds have a similar purpose in investment in microfinance in social and financial return, but their targets – the final beneficiaries, the regions of operation, the programs, and the indicators – are different. So a list of social mission guidelines in investment section criteria is vital.

> *MicroCredit Enterprises gives priority to microfinance institutions that:*
>
> - *Serve a high percentage of deeply-impoverished individuals and families*
> - *Serve a high percentage of women*
> - *Extend operations to isolated rural communities*
> - *Operate or provide linkages to comprehensive social service programs, such as women's empowerment, financial literacy, health education or services and business training for micro-entrepreneurs.*

Management Quality

Twenty three of the studied funds mentioned to invest in MFIs who have sound management structure. Acceptable management structures in this study include good internal controls, clear operation procedures and division of responsibility, satisfactory corporate governance, and skillful human resource management. Funds sought to partner with MFIs that employed a skilled and ambitious management team who had expertise and experience within the institution's scope, and a strong intent to generate attractive return to MFIs, and an active board and executive who are satisfied with their positions and tasks. Also important is transparency (disclosure of information), ownership, high standards of business ethics and client protection principles, and appropriate responses to country regulations.

Eligible MFIs had to hold all relevant legal documents, such as: lending policy to comprehensively explain the methods and tenure of lending, the maximum amount of loans, interest payments and penalties; a business plan which clearly determines the projected financial feasibility and future financing needs; and a development strategy which introduces local social and environmental practices. MFIs must also possess adequate back office and a reliable communication system, including telephone, fax, and ideally efficient email capacity. Any MFI with a Management Information System (MIS) was at an advantage, but this was not a key requirement, depending on the type of MFI. If a MFI was chosen as an investment partner, an MIS would be provided and trained by the fund manager.

> *The Investment Fund will invest in MFIs, which are managed by experienced and ambitious teams who are capable of turning their mission, vision, strategy and business-plans into reality (Incofin-Impulse Microfinance I)*

> *We invest in management teams with a proven track record in their field of operation and an ability to articulate a clear vision and strategy, reinforced by a viable business plan. The organization must practice exemplary governance with operational efficiency and controls, transparent practices, and disciplined financial planning (Omidya)*

Operation and Outreach

Twenty two funds mentioned operation and outreach quality in their eligibility criteria. Operation quality in this study refers to any MFIs which showed good operation performance in providing a wide range of innovative ideas for well designed products and service delivery, in that their micro-loans were provided with the technical support and regular training on business initiatives and basic bookkeeping, etc. MFIs had to periodically monitor their client's use of loans, immediately taking action where necessary to prevent losses. Some funds set a limited ratio of operational self-sufficiency (OSS) for an MFI, for example over 95%. MFIs also had to have a good outreach qualities, such as clear target groups: who and where they are working with (their geographic and individual focus), the minimum of current clients (e.g. serving at least 5,000 borrowers), the number of clients to be reached (in men, women, poor, small entrepreneurs, etc.,), and so on. MFIs then must have strong commitment to reach that target group with positive impact from the financial services provided.

In practice, the operation and outreach are linked. Operations expand through building more branches, recruiting more staff, providing greater loan size to a larger number of clients, and distributing products or services to new regions. These activities also broaden outreach in depth and breadth. The outreach focus is associated with sustainability of institutions, so it is precisely integrated in investment decisions because it informs investors (the microfinance funds) whether or not an MFIs is capable of generating income from those target groups. For example, MFIs obviously cannot make a profit if they serve the very poor who lack not just capital to start a business but also a reliable income source or skill, or who live in remote and sparsely populated areas and have to pay a high interest rate corresponding to the high costs (Zerai & Rani, 2012). The MFI's operation and outreach can influence investment outcomes, so it can be a useful selection criteria.

> *The MFI should has strong potential and intention to achieve scale in frontier areas. Current quality of outreach (e.g. percentage of female borrowers). Commitment to serve the hard to reach population. A clear business model that shows potential for financial sustainability. (Dutch Microfund)*

Portfolio and Financial Quality

There were 30 funds that mentioned the needs of the loan portfolio and financial quality as a factor in determining the eligibility of MFIs. The required financial management includes good treasury management, sufficient asset to liability ratio and liquidity management, the ability to regularly produce financial reporting, and the external financial audit in past years. In addition, MFIs must have good past performance, such as a positive cash flow from operations, a track record of raising and repaying debt capital, an acceptable level of indebtedness, and an agreeable debt to equity ratio. Moreover, a qualified MFI must well manage and regularly monitor the level of a loan portfolio to ensure delinquencies are under control to reduce defaults and to maintain minimum portfolio at risk (PAR). We found microfinance funds desired MFIs with a debt to equity ratio not more than 5%, PAR<30 was lower than 5%, while some accepted greater than 5% but not higher than 10%. MFIs must also have a desirable loan portfolio outstanding - most funds targeted MFIs with loan portfolio at least US$1,000,000.

The financial performance and loan portfolio quality can determine the stage of development, efficiency level, and repayment capacity of microfinance institutions. In practice, the large and mature MFI are often bigger than other MFIs in terms of loan portfolio and number of borrowers, with better managed financial and loan quality. So it is handful information to be examined for investment decision making.

> *MFIs with following characteristics will be invited to apply: 1) Track record of minimum three years of operations. 2) Commercial viability evidenced by historical positive cash flow. 3) Active loan portfolio > 2 million Euro. 4) Sound portfolio quality performance.(Incofin-Impulse Microfinance Investment Fund)*

> *JAIDA's eligibility criteria, microfinance institution need to:*
>
> - *Have been in business for at least two years*
> - *Have an agreement for operations from the Finance Ministry*
> - *Have audited financial statements for the last two years*
> - *Show an acceptable level of indebtedness*
> - *Show Sufficient profitability*
> - *Have reached operational self-sufficiency*
> - *Maintain an acceptable credit portfolio quality*
>
> *(JAIDA)*

5.1.3 The Eligible Partners

The third sub-question in this study seeks to determine what microfinance funds desire as their target partners. Eligible partners refers to any sorts of microfinance service providers that funds wish to invest in. As already discussed in chapter: 2, these providers can be categorized into different types depending on various determinants. MFIs can be classified by ***Tier*** based on the level of their commercial orientation. Dieckmann (2007) classified MFIs in four tiers, defining tier 1 as mature and profitable, tier 2 as smaller, younger and nearly profitable or simply less well known, tier 3 as approaching profitability and searching for more capital, with tier 4 comprising start-up MFIs and NGOs. Conversely, CGAP defined their tiers based on total assets. MFIs with an asset value over US$30 million make up tier 1, between US$5 million and US$30 million in tier 2, and under US$5 million in tier 3 (see more in section: 2.3.1).

The textual information on the websites of microfinance funds was not suitable to be translated and codified by tier due to a lack of detail. For example, funds frequently mentioned to MFIs in a single word, such as a start-up, young, mid-size, existing, large, well-run, advanced, established, or sound and feasible MFIs. As a consequence, tier coding has relied on manifest content. Among the studied funds, there were only five funds that showed their eligible partner by different tiers. Only Incofin-Impulse Microfinance Fund targeted to MFIs in tier 1, while four funds (DB-FINCA Microfinance Fund, Gray Ghost, Incofin-Impulse Microfinance Fund, and Riskebiz) focused on tier 2, and two funds (Oxfam-Novib Fund and RISKebiz) to tier 3.

On the other hand, the eligible partners can be categorized by **development stage** of institutions. Theoretically, a MFI develops in four stages: start-up, expansion, consolidation, and integration stage, as they become a full fledged financial institution intermediary. In the start-up and early expansion phase, microfinance programs are largely subsidized and granted by donors or development agencies, while starting to look for additional financial resources from commercial investors at the end of the expansion and beginning of the consolidation stage. Grants or subsidies are reduced once institutions are more mature, then financed by private investors who are social responsibility minded (see section: 2.3.4).

However, microfinance service providers in this study were only classified into three stages: emerging, expanding, and mature. Small, start-up, young, early, emerging, etc. were codified into *Emerging stage* MFIs; mid-size, growth-oriented, well-established, promising future, sound and feasible, process of transforming, existing, high potential, innovative, and client-driven were coded as *Expansion stage*; and the *Mature stage MFIs* were defined as regulated, sustainable, leading, large-scale, large and well-developed, sustainable operation, financial sustainable, and for-profit MFIs.

Such classification was found in 50 funds, representing 60% of the total. As can be seen in Table 5.3, only 31 out of 84 funds (37%) focused on making investments in expansion stage MFIs (the mid-size, growth-oriented MFIs), while 29 funds (35%) addressed the emerging stage (the small, start-up MFIs), and the mature stage (the large, sustainable MFIs) appeared in 15 funds (18%). Looking at the weight of coding theme concerning eligible partners was dominant in expansion stage, 41% (31 of 75 responses).

Table 5.3: Development Stage of MFI

Development stage	Frequency	% of funds presented	% of frequency
Mature stage	15	18%	20%
Expansion stage	31	37%	41%
Emerging stage	29	35%	39%
	75	89%	100%

From this data, we can classify the eligible partners for investment funds by charter type i.e. those institutions who mainly provide microfinance services or who include microfinance services in their operation, including banks, credit unions/co-operatives, non-bank financial institutions (NBFI), consumer lending companies, technology companies and other MIVs (CGAP, 2007a). We found that 47 funds, or 56%, mentioned these microfinance service providers. Major banks (commercial and development banks) were cited in 16 out of 84 cases (19%), and 16 out of 91 responses (17%), followed by SMEs, microlending companies, NGOs, credit unions, NBFIs, other investment funds, that made up more than 10% but not over 15% of either of total funds or total responses. The occurrences of sub-categories such as fair trade, technology companies and housing developer or leasing companies was relatively rare (see Table: 5.4).

Table 5.4: Eligible Partner by Charter Type

Charter type	Frequency	% of funds	% of frequency
Commercial bank	4	5%	4%
Development bank	12	13%	13%
NBFI	9	11%	10%
Other funds	8	10%	9%
Technology com.	4	5%	4%
Housing;leasing	6	7%	7%
NGOs	10	12%	11%
Credit union	10	12%	11%
Microlending com.	11	13%	12%
SMEs	12	14%	14%
Fair trade	5	6%	5%
	91	108%	100%

According to this finding on the eligible partners by charter, and the literature of microfinance in section 2.2, we can further define the target partners of microfinance funds by **type of microfinance service providers**: formal, semi-formal or informal institutions. Formal institutions were most often cited, followed by semi-formals. There was no information that could be grouped into informal institutions. 43 microfinance funds (around 51% of the total) were included in the formal institution category, consisting of commercial banks, development banks, and non-bank financial institutions such as leasing companies, housing developers, investment funds and technology companies, while 31 funds (37%) were categorized as semi-formal institutions, such as NGOs, credit unions and co-operatives, and micro-lending companies.

More importantly, some funds extended their investment activities and objectives into relevant sectors of microfinance. Funds targeted SMEs and fair trade orientations which were compatible not only with their social missions but also their investment management expertise. Referring to Table: 5.4, 12 funds disclosed additional investment in the SMEs, while five funds referred to fair trade or producer associations. Funds could provide loans directly to SMEs, bypassing MFIs; "these funds act as ultimate financial service providers". For example, EFSE was tailored to make microloan directly to SMEs located in rural areas for agriculture productivity, livestock and agro-processing, and for housing. Also, funds could finance other microfinance funds that offered loan or capital to MFIs. These funds play a role as investors in other funds, not as direct investors in MFIs.

This finding is similar to the recent report of CGAP which showed that some large funds are extending their investments beyond microfinance (agriculture and small enterprise). Oxfam and Symbiotic announced to launch a Small Enterprise Impact Investment Fund in January 2012. ACCION launched a US$10 million Venture Lab fund, seek to open financial access through categories such as technology, education, energy and housing by focusing on innovative start-ups (Moretto & Glisovic, 2012). The diversification into these adjacent sectors can lead to some concerns that funds no longer concentrate solely on funding in MFIs; in such a case the main fund objective of principally investing in microfinance should be modified, while the flow of capital from this fund into the microfinance sector can be reduced.

> *We also provide credit to trade cooperatives, fair trade organizations and small-to-medium enterprises (SMEs) in the developing world. (Oikocredit)*

> *responAbility: We focus on offering financing to: Microfinance institutions and microfinance banks, fair trade institutions and small producer institution, SMEs that create value at the base of the pyramid.*

5.1.4 The Key Products and Terms Offered to MFIs

Financing Instruments

Financing instruments are generally defined as documents such as share certificates, bonds, and promissory notes that are used to acquire financial resources, either in equity capital or a loan for a business purpose. Currently, financing instruments can be characterized as equity based or debt based. The financing instruments offered to any eligible institutions are different depending on the mission and scope of the investment, the financing need (capital or loan), the performance of institutions, the regulatory framework, the development level, and the readiness of the financial system (Ledgerwood, 2012). In addition, the many tools that are used to provide financing are tied up the various terms of investment, including size, length, currency, collateral, level of return and risk. So financing instruments are also one of fundamental components contained in the investment strategies of microfinance funds, and form the fourth sub-question in this research.

We found all studied funds exhibited the types of instruments used in investment in any eligible MFIs. The financing instruments in this study were classified generally into three types: equity, loan/debt and loan guarantee. Table: 5.5, illustrates that a large number of funds made investment in loan or debt instruments, represented 74% of total funds (n=62), followed by 56% in equity (n=47), 30% in loan guarantee (n=25), and 27% (n=23) in other tools such as quasi-equity, term deposits, grants, and financing via technical assistance. In weighting the category, we found the most common type of financing instruments was loans, 62 out of 157 responses(39%).

Table 5.5: Type of Financing Instruments

Financial instruments	Frequency	% of funds	% of frequency
Equity finance	47	56%	30%
Guarantees	25	30%	16%
Loans	62	74%	39%
Other	23	27%	15%
	157	187%	100%

Investment in ***equity*** represents microfinance funds' ownership of the invested MFIs. It was found that funds invested in common and/or preferred shares of selected high potential MFIs, of which some intended to acquire minority equity stakes from their capital. Through such investment, funds also attempted to oversee and participate in on boards, and to establish and maintain a long term partnership with invested MFIs while seeking a competitive return on equity. Most funds further mentioned the retention of dividend for capitalization and growth, but expected to get returns with a reasonable rate.

> *We do not intend to draw dividends but instead aim to capitalize MFIs well and aim for a healthy but fair return over the life of the fund. (Agora)*

Although such investment benefits microfinance funds in having more influence and ownership in invested MFIs, it is a comparatively higher risk strategy, so funds need to scrutinize the ownership as part of their risk calculation in investment decision making. Similarly, MFIs need to pay attention to how ownership supports their growth and its limitations, or it will influence their future funding structures (USAID, 2007). Moreover, through this study we found that among the 47 funds that made investment in the equity of institutions, only 10 funds (21%) employed just equity, and as such could be considered as pure equity funds; based on CGAP (as cited in Symbiotics, 2011) findings, which defined equity funds as investment funds and vehicles with more than 65% of their total non-cash assets invested in equity investment.

Financing in **loan/debt instrument** generally privilege a high level of repayment in the event that institutions run into financial problem and cannot repay all their obligations. Traditionally, loans only refer to an amount of money lent for the fixed period of time, that must be repaid with interest, but innovative techniques have led to a wide range of types based on expectations and needs of lending. Similarly, loan/debt instruments that microfinance funds use to finance MFI have been more varied, consistent with the funding objectives and structures of the funds. This diversification is a response to the specific need of MFIs as they develop, given the more complex capital structure, the increase in competition, or the need of complementary sources for the local lender and capital markets. Microfinance funds increase their range of loan products by differentiating their funding structures, such as senior loans, subordinate loans, and junior loans. Each loan product contains unique characteristics, different pricing, length, interests, returns, risks, and objectives of the microfinance fund in offering such loan to MFIs.

The greater occurrence of microfinance funds financed through loan/debt instruments in this study correlates with previous studies that often found that debt investment, while still dominant, has been starting to decrease (see section: 3.5.1). In addition, 19 out of 62 funds (31% of 62 funds), financed only in loan or debt instruments; they can be called debt or fixed income funds in this study. And according to CGAP (as cited in Symbiotics, 2011), fixed-income funds and debt funds are defined as investment funds and vehicles of which more than 85% of their total non-cash assets invest in debt instruments.

> *JAIDA offers products that are well adapted to the needs of the microfinance sector in Morocco, at this stage of its development. Today, two types of loan products without guarantee are offered to the microfinance institutions:*
>
> - *Senior Loans that support the portfolio growth of microfinance institutions directly.*
> - *Subordinated Loans that strengthen their capital base in view of increasing their capacity to take on further dept financing.*

> *The FPM offers a range of products tailored to specific needs of IFP. The product offering financing is structured according to the needs of each segment targeted by the FPM and individually adapted to each counter-party. These products include*
>
> - *The senior loans: These products are intended to finance portfolios of MSME IFP and thus to support their growth.*
> - *Subordinated loans: aimed at strengthening equity,*
> - *Special loans: These products are intended to finance specific niches with more favorable characteristics. For example, these products are for IFP financing agricultural activities (not currently funded by industry) or provides services to areas not covered.*

Instead of directly lending to MFIs, microfinance funds indirectly open financial access through supplying **loan guarantee**. Loan guarantees were mentioned as an essential credit insurance that funds provided to commercial funding markets, banks, and local banks to make a loan to an MFI. Loan guarantees also helped to bridge microfinance to the commercial financing sector. Funds distributed a Standby Letter of Credit and/or direct deposit in local banks to secure not only a loan or line of credit which MFIs desired to borrow, but also to guarantee fixed-income instruments issued by MFIs. For example, IFMR Capital guaranteed second loss default of micro-loan back securities when there was securitization in an MFI. In this case, it meets the theory that a guarantee is an effective strategy in a risky situation i.e. structuring loan products or the issuance of new products. In addition, funds secured a loan portfolio of MFIs by connecting and making agreements directly to a particular group of MFI clients. The portfolio guarantee in this study involved the agreement of funds to cover a fixed percentage of any potential losses of the loan portfolio in excess of the MFIs' average historical loss rate (certified by an external auditor).

> *FIG's portfolio guarantees are direct agreements between FIG and the beneficiary MFI. They secure an MFI's particular group of clients, by covering a percentage of potential losses. For the beneficiary MFI, FIG's portfolio guarantee works as credit insurance.*

Furthermore, of the 84 funds studied, 17 employed all sorts of investment instruments (loans, equity, guarantees, quasi-equity, term deposits) which we categorize as diversified funds. 11 funds used three types of financing instruments (loans, equity and loan guarantees), while 30 funds provided either loans or equity instruments, 16 of whom found funding solely in debt and equity. These 16 funds are are possibly defined as mixed funds, according to CGAP (as cited in Symbiotics, 2011) definitions: any investment funds and vehicles that invest in both debt and equity, where investment in equity is more than 15% but less than 65% of total non-cash assets, are called mixed funds. However, the limitations of asset proportion in this definition mean we cannot assume these 16 funds fall into this category.

Microfinance funds additionally disclosed their strategies in allocation of assets by setting up individual limitations of financing by each tool, to get a balance of investment distributions as well as to reach their stated objectives. For instance, *"63% of the NMI portfolio was allocated to debt investments while 37% was allocated to equity investments (NMI)."* We also found themes regarding the aims of investment either in equity or debt are in accord with the Symbiotics (2011) study showing that investment in equity seeks to hold shares in only a handful of MFIs, whereas those investing in debt and mixed instruments tend to diversify their risks in a wide range of MFIs across different countries.

> *LMDF offers loans to finance the growth of the microfinance portfolio of these MFIs, invests in equity instruments issued by MFIs can also put in place safeguards intermediaries. On the basis of a guarantee made by LMDF, a bank in a developing country grants a loan to an MFI, usually in local currency. (LMDF)*

Beyond equity, debt and loan guarantees, investment through other tools, such as quasi-equity, term deposit, grants, and financing in technical assistance which were classified in the sub-category "others". The ***"other"*** subcategory was dominated by quasi-equity or convertible loans, followed by term deposits, grants, and financing in technical assistance. Most provided technical support to microfinance funds to consult and to help their investment succeed.

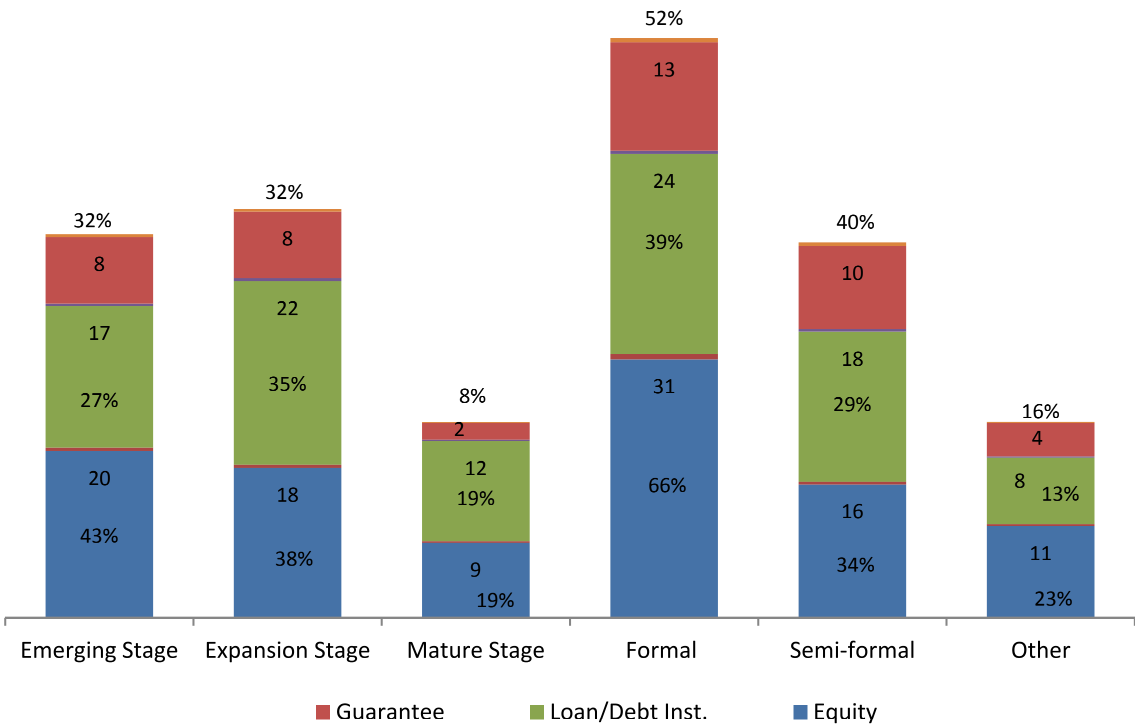
Quasi-equity refers to an investment that combines the characteristics of equity and loans. It includes convertible debt and typically invests in the high-risk start-up phase. It was found 13 funds also provided quasi-equity investment in eligible institutions. *"When needed, a portion of MicroVentures' investment in the risk capital of the MFI can take the form of quasi-equity instruments (microVenture Luxembourge)."*

Term deposit refers to the act that investment funds replaced their lending to MFI by putting agreed amounts of money directly into the MFIs for a specific period of time. With these deposit, MFIs can extend lending to clients, expand operations and use it as leverage for additional sources of capital. *"Terms deposit with maximum placement length of 12 months will be placed in the selected MFIs. The MFIs should then use the proceeds of time deposit to create micro working capital credit to support micro business (BISMA)."*

In this study we further investigated which types of financing instruments are dominantly used to provide funding to each type of eligible partner. We found that the 47 equity financing funds invested largely in emerging stage or formal microfinance services providers, represented respectively 43% (n=20) or 66% (n=31). The 62 debt financing funds concentrated in the expansion stage and mature stage or in semi-formal institutions, each accounting for 35% (n=22), and 19% (n=12) or 29% (n=18) of 62 funds respectively. The major distribution of loan guarantees was equal, 8 out of 25 funds (32%), in the emerging stage and expansion stage. In addition, the adjacent sector of microfinance such as SME and fair trade in this study were financed in capital investment rather than loans (see Other in the Figure:5.1). These sectors were discovered as a new expansion of some microfinance funds, and it was interesting that financing was generally made in equity, which is seen as riskier and a longer-term return on investment.

This finding corresponds to the relevant literature that equity and grants are greater proportion of funding for greenfield/start-up/early stage institutions, while debt financing is normally for mature institutions that are already able to generate sufficient income to cover costs (Ledgerwood, 2012). Basically, equity capital is provided for start-up costs, such as establishment of organizational infrastructure, capacity building, and promotion of financial services and products, support in regulatory requirements, and to secure lenders to provide loans. Guarantees also show a very significant foundation in the start-up phase to bridge MFI to get more alternative sources of funds. Loan or debt investment generally aims to fund portfolio growth or refinance maturing debt. Formal institutions are primarily funded by both debt and equity funds, on the basis that investment funds target to invest in regulated MFIs who have potential for profit and growth.

Figure 5.1: Financing Tool by Eligible Partner



Maturity

Investors set a range of investment maturities according to their objectives and funds available. 28 funds talked about the tenure of investment on their websites as below:

Debt investment: The length of debt financing varies, starting from six months up to seven years, but we found the majority were from one to five years, while three funds (BOMS1, Goodwell, and Grameen CreditAgricol) lent up to seven years. Subordinated debt can be extended from five to seven years, but not over 10 years. According to Microrate (2012), microfinance funds have diversified their debt products to compete with local lenders by offering more subordinate debt and prolong the maturity of senior debt from two to three or four years.

Equity investment: Investment in share capital of MFIs is recognized as a long term investment horizon, start from four years up to ten years, and not longer than fifteen years, while some funds do not state the length of their capital investments, only stating that they have taken a minority stake in an MFI.

Loan guarantee: can be made from one to five years.

Term-deposit: for a maximum of twelve months MFIs can use deposited amounts to relend to micro-entrepreneurs.

Investment Size

Thirty two funds displayed the size of investment in a single MFI. Certain funds provided a specific range of investment while some just presented the limitation in percentage of funding compared to the total assets or equity of the eligible MFI. In parallel with maturity, the investment size was seen in a ranges depending on the target groups, objectives and available funds, commencing from US$50,000 up to US$3.5 million. Exclusively a fund showed very high maximum of funding, i.e. NMI between US$3 million and US$8 million, to the growth and expansion of established MFIs. However, most frequently they ranged from US$1 million up to US$3 million.

Instead of limiting the exact amount, some funds made investments based on the availability of total assets or capital of a qualified MFI, or on the total available lending capacity of the fund. This was also a reason that funds listed a limitation of maximum total asset/capital of MFIs as part of their investment criteria, lending not over 100% of the institution capital, equity investment might not exceed the 10% , 20%, 25% or 30% of total assets of an eligible MFI. Those funds who provided loan guarantee services to MFIs showed that their bank guarantee did not cover more than 35% or 50% of MFIs' gross loan portfolio.

> *Policy One: The total loan amount to any single MFI shall not exceed 10% of MicroCredit Enterprises' total available lending capacity. Policy Two: MicroCredit Enterprises' loan portfolio exposure in any single country shall not exceed 15% of the total outstanding loan portfolio. In order to manage a dynamic, growing loan portfolio and respond to special circumstances, the Loan Committee is authorized to exceed this limit only by unanimous vote and only for a limited time period.*

> *With its Equity investments, the Fund will take substantial minority positions and be an active investor. Investments will have target average investment size of approximately US$2 million, but can also be smaller or larger, up to a maximum of US$6 million. The minimum investment will generally be US$1 million (Frontier).*

Currency

The currency classification chiefly depended on the obvious: hard currency, in USD, EUR, CHF, or the local currency. However, these categories were also coded through latent content where funds mentioned that they invest only in institutions in a country where funds were also situated. For example, Indian investment funds who work for only in India, such as IFMR, IFI, LockCapital, PCG, were automatically classified into the local currency sub-category. There were 47 funds (56%) exposed the kind of currency usually used to finance eligible MFIs. Among those, we found the number of funds invested in hard currency and local currency was very slightly different: 33 funds (39% of total funds) for hard currency and 31 funds (37% of total funds) for local currency (see Table: 5.6). Previous studies often found investment in microfinance was predominantly made in hard currency. The vast majority of MIVs were debt investments, 70% of that debt made investment in hard currency (Reddy, 2007), as was 92% of all international debt issued to MFIs (Mark, 2007). Similarly, in this study, financing in debt was primary, around 50% of 62 funds (n=31) made in hard currency while financing in both local and foreign currency is significant.

Table 5.6: Type of Currency Made in Investment

Currency	Frequency	% of funds	% of frequency
Local currency	31	37%	48%
Hard currency	33	39%	52%
Both types of currency[a]	18	21%	
	64	76%	100%

[a]This was not created as a subcategory but shows any funds coded to local and hard currency simultaneously

Microfinance funds use a flexible approach of investment by issuing in both hard or local currency where hedging mechanisms are available, because currency risk is one of the major risks in investment in microfinance. Among 47 funds, there were 18 funds (21% of 84 cases) providing either local or hard currency in their investments, where hedging mechanisms were available. Where funds finance in hard currency, and the MFIs lend to their clients in local currency, this may lead to MFI losses from the depreciation of local value. It is suggested that making the investment in local currency is better way to add value in MFIs to minimize the risk (we will discuss this in detail in the next section 5.1.8). Investors are increasingly developing hedging mechanisms to promote more local currency investment, but most funds are still small and unable to afford the cost of hedging (Reille et al., 2011). Local currency investment in MFIs reduces costs and risks for the MFI, and are becoming more common [41]. Notably, investment funds are increasing progressively in supplying local currency capital to MFIs. For instance, the largest MIV managers had a third of their global portfolio effectively in local currency in 2011, and some at a remarkable level (e.g. Oikocredit had 56%). Some DFIs such as AFD and IFC in Sub-Saharan Africa have 100% debt portfolio in local currency (Moretto & Glisovic, 2012).

Date of Payment

Only nine funds (11% of 84 funds) mentioned payment of MFIs in terms of interest and principal of loans. Repayment installments can be made quarterly or semi-annually, typically paying interest only or together with partial principal or including a balloon payment at maturity. Meanwhile, repayment schedules can be made on the cash flows basis of a MFI, in line with MFI client needs, depend on negotiation and agreement between funds

[41] CGAP, http://www.microfinancegateway.org

and the microfinance provider.

Collateral

Ten funds (12%) demonstrated whether or not they required collateral when funding any institutions. Among those, four funds (Calvert, JAIDA, Grameen CrÃ©ditAgricol, and Lockfund) claimed not to require any guarantee when loan products were offered to qualified MFIs; investment was structured as a general recourse obligation. Whereas five funds (CRESUD, Incofin-Impulse, Frontier, Microvest, and Minlam) required adequate collateral to ensure liability against the investment either by loan, equity or loan guarantee. There were various types of security, such as cash collateral, a loan portfolio or part thereof, hypothecation of assets, real estate, other fixed assets, or guarantee, a mix of the instruments such as stand-by letters of credit, bank/third party guarantee, fixed-term deposit, mortgages, personal guarantees, portfolio endorsement, etc.

Any MFIs that could access a particular amount of credit from a local bank by intervention of loan guarantee funds also had to put up a partial amount of the loan as collateral. For example, where using a bank guarantee, FIG required MFIs to pledge 10% of the guaranteed amount as collateral. The fund recognized that it was hardly possible to provide loans against collateral or obtain guarantees when making equity investment in the microfinance sector. However, the fund still insisted on a safe guarantee for certain investment in microfinance to reduce investment risks.

5.1.5 The Process of Investment Selection

The investment selection process is an essential part of the investment strategy of microfinance funds, involving subsequent stages that fund managers have to perform for robust decision making. The fifth sub-question in this study asks what are the processes of investment selection by microfinance funds, and what fund managers generally do in each step. This process generally commences with screening and identifying the eligibility criteria and partners, and ends with investment approval and the disbursement stage. Among the 84 funds, there were only 22 (26%) that presented their investment processes on their website. Of those, only seven funds (32% of 22 funds or 8% of 84 funds) showed precise procedures in detail, while the rest added a sentence or two describing some of the steps. In this study, it was found the process of investment selection was fundamentally made through seven successive steps, including screening, investment analysis, due diligence, investment approval, portfolio construction, reporting, and ongoing monitoring. The occurrences of each step were figured out in similar number, ranging from 13 to 17 funds, except the portfolio construction stage which was used by very few (see Table:5.7). The number of steps was consolidated to six.

Table 5.7: Process of Investment Selection

Process	Frequency	% of funds	%of frequency
Screening and Identification	17	20%	18%
Market source, Investment analysis	18	21%	19%
Due diligence and review	15	18%	16%
Investment approval	15	18%	16%
Portfolio construction	3	4%	3%
Reporting	13	15%	14%
Ongoing monitoring	13	15%	14%
	94	112%	100%

Identification

The screening and identification stage appeared on 17 fund websites. Screening and Identification in this study refers to the phase of making contact and reviewing the eligibility criteria of MFIs. It involves searching, sharing documents between funds and organizations, and learning from each other. The essential documentation which was needed to submit to microfinance funds, including audited financial reports, organizational structures, operational information and so on was usually listed on the website of investment funds. MFIs had to complete and provide all of those documents so that funds may take an in-depth look at the application to screen and identify them, relying on the internal investment criteria established by the investment committee. Some funds, particularly large funds such as BlueOchard, have their own online database which requires an applicant to complete and to share financial and portfolio information. Before developing a report for the investment committee according to the information provided, funds could contact applicants for additional questions and supplementary information or for a short interview, otherwise the application would not be considered. Funds also needed but did not require the external ratings and performance evaluation report of the applicant, which would be viewed favorably in the analysis phase.

Market Survey/Investment Analysis

Once a potential applicant has been identified, the application and a report related to the applicant are sent to an investment committee, composed of internal and external microfinance experts, to do a market survey or investment analysis before making a decision. The analysis is not only in terms of what MFIs do to benefit their societies and countries, but also what they could bring to investment funds. Funds study the information supplied by the applicants to obtain a deep understanding of their overall plan, business model, the impact and objectives of the applicant, and to examine all relevant aspects of feasibility and coherent risks. To prevent failure of investments derived from risk arising from markets, the environment and counterparties, funds need to evaluate the business plan, the economic and political status of the country, restrictions, currency, risk tolerance, market position, management and human resource quality, product development and innovation expertise, and the regional and external network of an applicant's organization, based on established selection criteria (management, portfolio, and financial quality, as discussed in the section eligibility criteria: 5.1.2). Some more high-tech funds among the 18 also said that they would establish computer systems to analyze the applicant's information and compare it with their own investment eligibility criteria. Funds carefully analyzed the financial conditions and impact by applying either qualitative or quantitative approaches to address financial and social performance and repayment capabilities before making a recommendation to management to approve or reject financing. Funds might negotiate the financing conditions with applicants then give preliminary approval while prepared an initial draft term sheet.

Due Diligence and Review

After the selection of an identified MFI in the end phase of investment analysis, funds usually undertook a preliminary on-site due diligence visit to this institution and its branches to examine their operation and performance. We found 15 funds (18%) described due diligence in the investment process, to verify that the information provided conformed with reality through an in-depth investigation at the ground operational level. Microfinance funds wished to determine and understand the soundness of operation, the financial and organizational history of MFIs, and to develop a relationship of mutual confidence with the MFI's management before making a final investment decision. The investment officer often spent a two to three days visiting an MFI office to meet with senior managers, regulatory authorities (central banks), operational staff and clients. At the end of the first visit, funds and MFI management generally discussed any areas that had been identified as needing improvement, potential changes, and the initial draft of terms sheet might be revised depending on their final discussions. Due diligence typically entails a review of the basic management and operational systems and a careful analysis of the financial institution's business model (R. Christen & Flaming, 2009).

Investment Approval/Loan Disbursement

Fifteen funds (18%) mentioned investment approval, was often made by the investment committee or staff, depending on the size and risk of transaction. Funds and MFIs finally negotiate the terms and condition of a loan, agreeing on legal documentation, and sign approval on those document before the fund issued the loan commitment letter. The schedule of investment disbursement was determined according to effective demand for funding and the absorption capacity of each qualified MFI. The total investment amount can be paid out at once or in installments over several quarters. The processing time between applications and financing disbursements varied from fund to fund depending on internal policies. Some funds said it would take at least 90 days from first contact to disbursement, while some took shorter, say two months after receiving the completed due diligence package from the identified MFI.

Reporting

Thirteen (15%) funds demonstrated that after investment disbursement, the MFI is obliged to provide transparent and accountable report to the funds either quarterly, semi-annually or annually. The report contains information on social impact, outreach, finances. Annual audited financial reports are also required. At the same time, funds need to make timely reports on portfolio investment and social benefit to investors and shareholder through various media such as newsletters, and internet bulletins.

Ongoing Monitoring

Since microfinance investment funds invest in MFIs that supply credit to their clients without securing the tangible assets to be seized or sold in case of default, MFIs might provide reports periodically to funds for ongoing monitoring to control risk of losses. Funds might repeat the second and third step of the process (investment analysis stage and due diligence stage) to keep comprehensively screening and monitoring the financial and social reports, revising the terms of investment (if needed), and make an annual field visit throughout the lifetime of investment. Funds seek to find out the current issues, examine whether or not an MFI is improving operation systems, and closely watch an MFI's performance focusing on financial and social return from the investment.

Most of funds discussed their individual processes of investment selection in different phrases, yet the meaning and context of methods were similar, and can be summarized as in the Figure: 5.2, commencing with screening and identifying and ending with ongoing monitoring of investments.

> *Our investment process:*
>
> - Initial contact and analysis*: On initial contact, the Triodos investment officer will make a first analysis based on the information and financial you provide.*

- TERM sheet*: The investment officer will send you initial details of terms.*
- Site visit and due diligence*: The investment officer will pay a 2-3 day visit to your headquarters to meet with senior managers, co-workers and clients. Meetings with regulatory authorities (Central Bank) and other relevant authorities will also be scheduled.*
- Investment Proposal*: The investment officer will write a proposal for our Investment Committee, presenting a financial analysis, the results of the due diligence, a SWOT analysis, and a risk assessment.*
- Closing*: After approval by the Investment Committee, the legal contracts will be signed, and the money invested will be made available to you. (Triodos)*

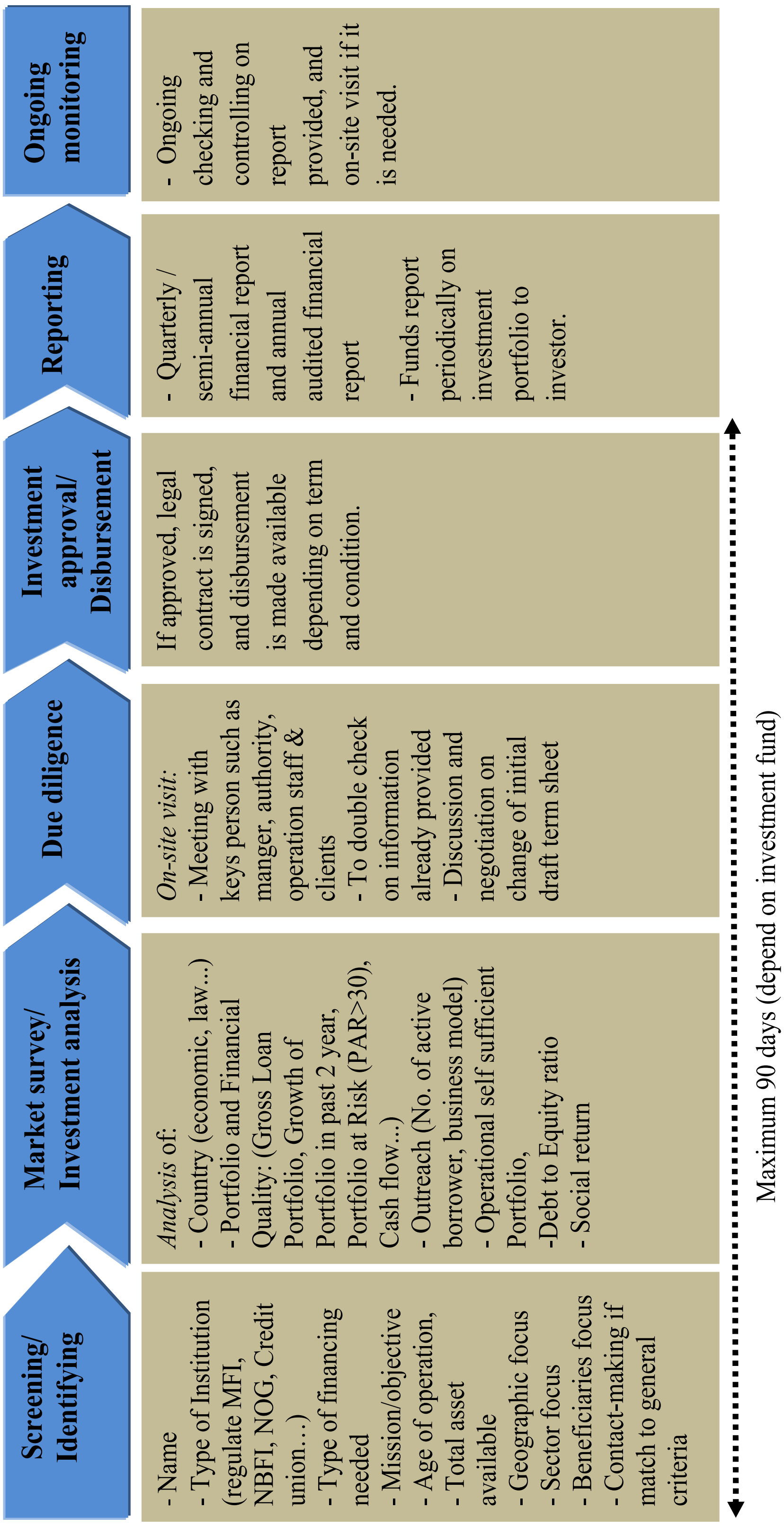
Investment process

- *The microfinance institution (MFI) provides all necessary documentation and shares financial and portfolio information in BlueOrchard's online reporting database*
- *If there is mutual interest, BlueOrchard undertakes an on-site due diligence visit of the MFI including meetings with top management and branch visit*
- *Regulation clearance and forex hedging mechanisms are set up (if required)*
- *Loan request is submitted to BlueOrchard's Credit Committee*
- *If approved, the loan disbursement is made*

- *BlueOrchard carries out ongoing monthly monitoring and an annual on-site visit provides full transparency for investors (newsletter, internet reporting, etc.)*

Typical process time (stages 1-5) New MFI: 3-6 months Existing client in good standing: 2 weeks . (BlueOchard)

Figure 5.2: Process of Investment Selection



5.1.6 The Funding Sources of Microfinance Funds

Funding Structure

The sixth sub-research question in this thesis concerned the funding sources for microfinance funds, to determine who are the main investors of microfinance funds, and what financial products are proposed to their investors. Only 10 funds (12%) displayed their funding structure, including their key financial products, their terms, interest payment and management fees, that are offered to investors. Generally funding was related to the financing instruments that funds used, as described in the section: 5.1.4. Financial products employed were on an equity and a debt basis, including senior debt, subordinated debt, first-loss tranches, or common stock/preferred stock.

Funds developed financial products to have various risk and return profiles, with the aim to satisfy the diverse needs of a variety of investors, as well as increasing the portfolio assets of the funds. In addition, funds further demonstrated that applying the mixed funding tool to finance their operation allowed investors from different sectors who had similar purposes - social impact and financial return - to conjointly invest in a diversified range of MFIs. In this case, investors might be able to add value through diversifying their portfolio investment, spreading out of the risk for specific operation which was sometimes better than stand-alone finance in a single MFI. Moreover, funds could also coordinate a direct relationship between investors and MFIs, where investors may occasionally decide to reduce interest rates on specific loans to those MFIs.

JAIDA refinancing structure features three risk levels:

- *Shares: Investors in this tranche assume the full risk of the funds, and - particular to JAIDA - bear only moderate return expectations. The tranche is reserved for public institutional* *investors who aim at a balance between financial and social return.*

- *Subordinated debt: Investors in this tranche assume a lower risk compared to shareholders, and investments bear a fixed term. Return follows commercial lines. This tranche targets public investors.*
- *Senior debt: This tranche bears the lowest risk. It targets private investors, notably the Moroccan financial sector. Terms and conditions are fully commercial.*

It was also found that funds created diverse well-designed structured products that were offered to investors at different prices and tenures depending on target investors and distribution channels. For example, for private investors, Calvert created a Community Investment Note, each selling at US$20 (on-line deal) for one to two years, at an interest rate of 2% to be paid at maturity with the principal, and US$1,000 (mailing cheque) for two to five years. The bearing bond and promissory note were sold primarily to qualified institutional and high net worth investors at distinct rates, from US$2,000 onward, without restricting the maximum investment, with a length at least one year up to three years (promissory note) and five years (bonds). These products are characterized with varied financial returns. The *rate of interest* was determined based on the amount and term of the product. Coupons could be provided semi-annually (June 30^{th} - Dec. 31^{st}), and while investment in equity products was not an attempt to distribute income to investors, dividends were automatically reinvested. Only five funds talked about the *fee of asset management*: those stated the cost of management of each fund were illustrated in the Total Cost Rate per year. These costs were not charged separately. The management fee raged from 2.2 to 4% per year.

Type of Investors

Some funds mentioned right away the sources of funding i.e. from institutional investors, individual investors, foundations, funds of fund and the public sector, so the funding sources were categorized by the types of investor standing in the manifest context. Meanwhile, some introduced the specific names of investors either by words or logos, in this case the coding was based on determining the actual types of those institutions (development agencies, NGOs, banks, financial institutions, foundation, etc.) to the type of microfinance investors studied in the section: 3.6.

At initial coding the investors who made an investment in the microfinance funds were classified in four types, including funds of fund, institutional investors, private donors/foundations, private individuals and public donors and investors.

Public investors refers to institutional funding to achieve the development goals, including bilateral agencies (CIDA, GTZ), multilateral agencies (IBRD, World Bank), development finance institutions (FMO, AFD, BIO, IFC, KfW, CAF, EIB) and local government agencies (USAID, SIDA).

Institutional investors comprises of commercial banks, insurance companies or pension funds, mutual funds, and private equity firms that are financially sophisticated and make large investments, often held in very large portfolio of investment.

Private donors includes foundations (Triodos Fonds, Ford, MacArthur and Mott Foundation, Deutsche Bank Americas Foundation, Calvert Foundation, Rabobank Foundation?), cooperation (IIC), Overseas Private Investment Corporation (OPIC), local and international NGOs (ACCION, Dutch NGO).

Private individuals are retail and high-net-worth individuals. Most funds displayed private investors or private local investors. Funds that create financial products and sell to public investors were also coded as private individuals as source of funding even where this was not explicit, such as Working Capital for Community Needs, Dual Return funds.

Fund of funds specifies investments made in other microfinance funds. Some fund invest either directly to MFIs or through microfinance funds such as BlueOchard, Triple Jump, Gray Ghost Microfinance fund, etc.; when they invested in a fund they were coded into the subcategory fund of funds.

Through study, 79 (94%) funds listed their current investors. Table: 5.8 shows that the vast majority of investors in microfinance funds were institutional, representing 55% of total funds (n=46), followed by 42% private individuals (n=35). 32% were public investors (n=27), 25% were private donors (n=21), and 21% were funds of funds (n=18). Among the total coding for the investor types (147), we found most coding associated with institution investors, accounting for 31% (46 out of 147 occurrences). This finding accords with the MIV survey result of Symbiotics (2011) that amongst 70 MIVs analyzed, private institutional investors were the largest source of MIV funding, at 45%, while investors from public sector were in the minority at 26%.

Furthermore, regarding the public and private sector, private donors and investors, including foundations, institutions, individuals, funds of funds, took the lead ahead of public donors and investors and stood for the greatest portion, 88% of 84 funds (74 funds included the private sector in their sources of funding, while only 27 funds had funding by public investors). Agreeing with the study of El-Zoghbi et al 2011, (as cite in Ledgerwood, 2012) on the sources of microfinance funding, it was found that the total funds flowed through investment funds (Microfinance investment intermediaries MIIs) were US$8.1 billion, in which the greater amount of funding US$5.7 billion, representing

70.4%, was made by private donors and investors, while US$2.4 billion was funded by public donors and investors. Noticeably, the public sector greater invested directly in microfinance institutions rather than via microfinance funds.

Table 5.8: Type of Investors

Type of investor	Frequency	% of funds	% of frequency
Fund of fund	18	21%	12%
Institutional investor	46	55%	31%
Private donor	21	25%	14%
Private individual	35	42%	24%
Public investor	27	32%	18%
	147	175%	100%

From this data we can infer that despite most funds being initially established and funded by development agencies or public donors, the predominant source of funding in microfinance funds, is private investors, most of whom are institutional investors, driven by social and financial objectives. The increasing in microfinance fund investing reflects to broader funding capacities in financial markets where public funds are limited, especially from institutional investors who are recognized as relatively new, do not have much microfinance experience, and intend both social benefits and profit. The needs of return diversification for institutional investors have led to an assumption that microfinance cannot be only for social development, but must also achieve a financial return for their investors. So the emphasis from private investors for focus on financial performance is likely to have a growing influence on microfinance funds in investment decision making.

5.1.7 Geographic Distribution of Investment

Geographic distribution in this study refers to the regions that microfinance funds have been working in, the countries where invested MFIs are located. The target region is a component of investment strategy, and also influences investment decisions, as we already discussed in "country context" in section: 5.1.2. The seventh sub-question in this research seeks to determine which regions are benefiting from microfinance fund distributions. The regional distributions were categorized into Africa, America, Asia, Eastern Europe and Central Asia (ECA), Latin America and Caribbean (LAC) and Southeast Europe, based on the names of institutions, countries, and regions. As some funds (e.g. subfunds of Incofin) showed their portfolio distribution in a pie chart instead of words or phrases, these graphic representations were also taken into account. 75 funds, accounting for 89% of total funds, talked about the geographic distributions of their microfinance investment.

The greater part of funds are distributed in Asia and Africa, 58% (n=49), and 55% (n=46) respectively, followed by LAC, ECA, and other regions (see Table: 5.9). 13 funds were coded into the sub-category "worldwide"; among those, four funds said that they invest in MFIs in developing countries around the world, or to MFIs worldwide. The remaining nine funds introduced their current regional distribution, and stated an intention to diversify their current distribution in other regions over the world, for instance, Incofin, CVSO, Oikocredit, and Creation Investment. The high weighting in the Asia and Africa sub-categories could be influenced by the coding method, where Asia included all countries listed in South Asia (SA), East Asia and Pacific (EAP), or the word "Asia". Africa, similarly, was not separated between the Middle East North Africa (MENA) and Sub-Saharan Africa (SSA), because some funds, such as Amber, ACCION, ASN-Novib Funds, Africap, stated Asia or Africa, without naming particular the institutions or countries.

This finding is especially true that starting from the late of 2009, growing numbers of private investors have financed funds, and the surplus capital has led some fund managers to expand their geographic focus to add portfolio value by actively seeking and investing in new regions where there is high growth in microfinance demand, such as India, Peru, Cambodia, Philippines, those are located in both region Asia and Africa. Similarly, according to a report by Symbiotics (2011), the regional distribution of microfinance portfolios between 2009 and 2011 showed impressive growth in EAP and SA, at 93%, and in MENA and SSA 86% in 2011[42], while investment in ECA declined steadily from 43% in 2008 to 34% in 2011. Demand for microfinance is high, but the quality of management and government is underdeveloped, especially in Africa, and funds managers remain concerned about over-indebtedness, and require rigorous consideration prior to investment.

Table 5.9: Regional Distribution of Microfinance Investment

Regional Distribution	Frequency	% of funds	% of frequency
Africa[a]	46	55%	24%
America	15	18%	8%
Asia[b]	49	58%	26%
Eastern Europe and Central Asia	27	32%	14%
Latin America and Caribbean	36	43%	19%
Southeast Europe	4	5%	2%
Worldwide	13	15%	7%
	190	226%	100%

[a]included Africa and Sub-Saharan Africa (SSA)
[b]Included the word Asia, South Asia (SA), and East Asia and Pacific (EAP)

[42]According to Symbiotics 2011 MIV survey Report: the growth rate of EAP was 26%, South Asia 67%, MENA 32% and SSA 54%

5.1.8 Risks and Returns of Investment

Risk and its Mitigation

Risk

In principle, the major risks of microfinance investment funds may be determined from existing risk in MFIs, as we already knew that the main portfolio of funds is microfinance assets. 40 funds (48% of total funds) talked about risk and risk mitigation. These funds often described the microfinance risk profile. Microfinance funds considered microfinance is a new asset offering lower volatility than other traditional asset classes (bonds/stock). Microfinance is isolated from macroeconomic shocks, shows a weak correlation to global financial movement in major market, political, economic or even climatic events. Because many MFI clients operate in the informal sector, they are somewhat free from the controls and constraints inherent in the formal economy. Microfinance assets are not yet listed on stock exchanges and not actively traded in capital markets, so the value is not influenced by unpredictable fluctuations in interest rates.

Fund also acknowledged that advanced MFIs are highly capable of meeting financial obligations, and have a low risk profile because the main assets of MFIs are the loan portfolio, which contains a very high quality of shorter loan maturity (six months to three years), higher repayment rates, and lower default rates compare to other commercial banks. Each type of MFI is characterized by different risk profiles and funding structures into which investment can be made, depending on the desire for particular return and risks. For instance, Planet Microfund emphasizes the need to accept risks when investing in very young MFIs in any countries where there is a lack of foreign investment.

Risk profile:

- *Lower volatility than emerging market equities and bonds;*
- *Low correlation with mainstream asset classes;*
- *High insulation from macro-economic shocks;*
- *Careful geographic diversification.*
  - *Investments are made in a wide range of currencies, but always hedged back to USD;*
  - *Share classes available in USD, EUR and CHF. (BlueOchard-Dexia Microcredit fund)*

Meanwhile, funds illustrated that the risk profile of underlying investors is determined by the level of acceptance of risk. To promote more investments in microfinance, funds issued shares of different classes, each with its own characteristics and based on a tiered risk sharing structure. It included A Shares and Notes (senior debt), B Shares (subordinated debt) and C Shares (first-loss tranche), each layer containing a different risk levels and targeted returns. Investors are given more opportunities to choose levels of risks and shared risks for specific operation among relevant parties, depending on their individual risk return appetites. The innovation of diverse risk tranches of structured products were appealing for a wide range of investors to participate in the same funding vehicle.

Some investors, generally donors and developing agencies, accept the high risk by investing in "first loss tranche" while other institutional investors prefer more secured products. This helps to diversify both risk and asset portfolio, and also to increase the term and amount of available funding. In fact, some funds, especially debt funds such as Dutch Microfund, JAIDA, REGMIFA,? established more structured products to motivate and tailor investors' demands.

> *As a Public-Private Partnership aimed at establishing a vehicle that holds funds from public and private investors, REGMIFA is structured as a multi-layer fund which reflects the risk/return requirements of its investors. To meet these requirements there are three Shareholder classes (A, B, C) and two Note holder classes (senior and subordinated), each share and note class having its own risk profile and targeted return (REGMIFA).*

> *There are risks contained in each investment category, investors are suggested to read carefully the prospectus of the funds, considering the risks associated with investment in various categories (Dutch Microfunds)*

Some funds also emphasized that there was no guarantee that loss from investment was impossible, as ASN-Novib Fund Microcredit said. The movement of return (profit or loss) depends on investment performance, and it is possible to gain little or no income, or increase in capital, or even sustain a partial loss of funds invested. FIG showed a historical loss rate less than 3%, and Calvert less than 1%. From this study, we found the thoughts of microfinance funds on relevant risks in microfinance investment agree with the existing theory, discussed in the section:3.9.2.

Risk Mitigation

Currency Risk

Funds did not show that investment in microfinance may face currency risk but they mentioned directly ways to manage this kind of risk. In practical terms, currency risk is a crucial issue in investment because the greatest number of investment funds are located in developed countries who get funding in

EUR/USD from investors, while most MFIs based in developing countries use local currency in lending to micro-borrowers. Consequently the income of MFIs is subject to volatility risk of exchange rate movement. The mitigation approach is costly, and a number of conditions apply, so MFIs rarely have adequate access to hedging mechanisms. Employing local currencies is a better opportunity for MFIs, but this may shift exchange risk to the lender, who may receive a lesser repayment.

Investment in microfinance is primarily in hard currency, usually in Euro or US dollars. Funds mentioned where investments are denominated in other currencies they may be subject to strict financial analysis and hedging operations. In the case of investment in foreign currency, both investors and the MFI need to mitigate risk by currency hedging with a specialized company. Currency hedging is an insurance policy to remove the fluctuation in value of foreign currency, so that the return from investment is not affected by currency risk (Bahtia, 2004). The range of hedging tools for foreign exchange risk is wider than what funds disclosed on the websites; not only currency swaps and third parties intervention, but also back-to back lending, forward contracts, and partial credit (Ledgerwood, 2012). 18 funds employed both foreign and local currencies in their transactions. They agreed to finance in local currency when there was sufficient hedging mechanisms, as local currency funding allows an institution to borrow in the same currency it lends, which is important to enhance the health of MFIs. The matching of the currency between assets and liabilities reduces exposure to foreign exchange risk.

> *Investments of the fund are primarily denominated in hard currency such as Euro and US dollar. In the fund, forex risk is hedged through currency swaps instruments. If investments are denominated in other currencies in the future, the fund may engage*

in the local currency hedge (Dutch Microfund).

NMI emphasize utilizing local currency when making direct investments in MFIs. To help manage and limit potential losses from such local currency investments, the NMI Frontier Fund may receive "first loss support" under certain circumstances through a special facility and funding provided by the Government of Norway through Norfund

Further, funds explained that in the event of foreign exchange loss, funds would share this with the MFI; in other words, rather than passing foreign exchange risk to the MFI, funds managed these risks in conjunction with their partner or investor. For example, all investors in C shares would be responsible for all losses and gains from foreign exchange operation, and the remainder of investors would not be affected. In addition, funds believed that the fluctuation of foreign exchange could be further minimized through building an adequate level of international diversification.

In most cases, the fund takes on the currency risk. Currency losses are limited due to the highly diversified portfolio. For higher risk currencies, the fund may choose to hedge through a specialised company. (Oxfam-Novib Fund)

Credit Risk

Credit risk is a potential risk, in the situation where an MFI is unable to repay a loan to the investor, or to generate income for shareholders. To protect against this kind of risk, funds introduced a rigorous analysis to assess and control it. The analysis was mainly carried out before deciding to make investment, as described in the investment selection process in section: 5.1.5.

The assessment of counterpart risk could be done by internal ratings focusing on country risk, market risk, currency exposure, and eligibility criteria. This rating is necessary to examine the financial health of institutions, and their ability to repay and generate a return from the investment. Most funds mentioned that only MFIs who satisfied the investment criteria of the funds (e.g. sound financial performance, good governance, clear target group orientation and prudent management particularly clear policies and procedure of credit lending), and/or were operating in a robust financial market where they would be able to withstand shocks and transfer risk, were selected. MFIs were also to be provided with the support in human and institutional capacity building. By financing MFIs who successfully passed such analysis, funds believed that their investment would be rescued from credit risk.

> *The assessment of counterpart risks is to a significant degree based on a prior investigation that focuses on the following points: Conducting a rigorous financial condition analysis; Assessment of the business plan; Evaluation of the management and the board of directors. (Incofin-Impulse Microfinance Investment Fund)*

Although there are external audits from third parties, funds still keep monitoring MFIs over the investment life cycle on either a regular report basis or ground visit due diligence, the provision of technical training if necessary for the growth of MFIs (the ongoing monitoring that is listed as the last step in the investment selection process as discussed in section: 5.1.5). Some funds have created a risk management framework or so-called watch list to identify vulnerable areas in order to be able to detect issues before they become a problem producing a loss. However, funds confirmed that uncontrollable risk is unavoidable: country risk, regulation risk, foreign exchange risk, natural disasters, and so on, so to secure portfolio investments from huge losses and to reassure investors, funds needed to purchase insurance from a creditworthy company.

> *Incofin IM's investments are exposed to various types of risks. Country risks include, for example, political risks (such as war or civil war) and transfer risks (the impossibility of recovering the invested means due to scarcity of foreign exchange or other governmental measures). To minimize these risks, we have an insurance policy with the National Delcredere service, the Belgian export credit insurer.*

Microfinance funds have developed innovative financing structures, with different risks for different types of investors, to benefit both funds and investors through offering many layers of risk protection. Funds also mentioned that credit risk could be spread by extending investments to finance in a wider pool of MFIs and relevant sectors, such as agriculture, SMEs, fair trade, education, housing development, etc., at different stages, with the restriction of maximum loan amounts of lending or capital investment to a single institution, and with limitations on their portfolio asset allocation. Building an adequate level of international diversification will also help investors to minimize risk of foreign exchange fluctuation. From this, we can presume that funds consider investment diversification as a good way to add value to their current portfolio and to reduce volatility. Further, funds believe that a well-established information technology system is vital for an MFI to prevent credit risk from clients as it helps keep track of loans due and repayments, to provide a report with information to collect loans in a timely manner. Incofin Impulse Microfinance Investment Fund highlighted the prevention of liquidity risk by setting up adequate liquidity management. Although there was no experience of loss among investors, Calvert still reserve a specific amount of money for investors in anticipation of this scenario.

> *We have over $28 million in security enhancements on a $200 million portfolio, providing many layers of protection for investors. This means that there is money set aside to be available to our investors in the case of portfolio loss (Calvert).*

> *MicroCredit Enterprises maintains a diversified loan portfolio to best manage the risks associated with its lending activities*

Return

43 funds (51%) talked about return, in different contexts. Interest rates on loan lending to MFIs was charged on a fixed or floating basis, depending on the loan agreement of each MFI and each country. Microfinance funds talked of providing reasonable returns to investors, generally seeking to exceed the yield of monetary instruments. Some funds, such as Microventure Luxembourg, Oxfam Novib Fund, and Respond Global Microfinance Fund, operated on commercial terms, applying a conservative investment strategy which provided well-timed, flexible, and demand-driven financing to selected MFIs with the purpose of receiving financial returns close to or slightly above the prevailing money market interest rate in either US dollars or Euro. In this case, the floating interest rate might be the most appropriate to apply, operating on the interbank rate in US dollars or Euro for a specific period.

We found very few funds (Calvert, BISMA, LMD) suggested that their investors expect returns from investment in microfinance at below market rate or near market rate, or lower than commercial structures in capital markets, since they were more concerned about social value than commercial profits. At the least, investors would never lose their real value of money invested, despite currency fluctuations. Microfinance funds would seek a fair and competitive rate of return on each investment, and the expected return from a new one might be made according to the overall portfolio return criterion and the objective of the funds. Moreover, funds also added that the required return might be diversified through investment type, currency lending, benchmark yields and pricing, maturity of the fund, risk appraisal and so on.

> *The investment's expected return should be consistent with the Investment Fund's overall target portfolio return criterion. On the one hand, since this is targeting a margin over the money market rates of return, for loans floating interest rates will be the more prevalent. These floating rates will be linked to LIBOR USD or EURIBOR 6 months. Equity investments will either be structured in preferred stock generating a steady return, or taken in very performing MFIs providing strong perspectives to generate an upside (Incofin-Impulse Microfinance Investment Fund).*

Interest rate charges on loans to MFIs vary at different stages of institutional development, or types of MFIs, depending on prior agreed amounts, and the structure of interest payments. For start-up and young MFIs, funds might charge low rates or sometimes provide technical support to assist with growth; such a rate would be adjusted when MFI achieved profitability based on cash flow, taking into consideration the proportion of start-up loan in the capital structure of MFIs. For more mature funds, financing in loan/debt instrument in this study yielded annually between 2.6% and 5.1% in US dollars, reflecting the fact that investors seek both social and financial returns.

> *Loans are typically structured with a base rate, which may be set low if the institution is not yet profit-making. As it reaches*

> *sustainability, the rate adjusts based on 1) the level of net income, and 2) the relative share of the Start-up Loan in the institution's capital structure. The maximum rate is capped at a pre-agreed level (Dutch Bank-Start Up fund).*

Equity funding can be structured in either preferred stock, generating a steady return, or common stock, acquiring ownership in the MFI, which provides strong support and perspectives to generate an upside. Funds financed in equity claimed that they had not yet generated significant returns due to being in the early stage of market development, even though underlying invested MFI showed very strong returns on equity. Funds said to support the long term goals, no dividend was paid out, and no income distributed, to allow reinvestment in the MFI to promote healthy growth. So microfinance funds carefully made decisions on investment in equity, representing an attractive longer term opportunity with higher return potential. .

> *Given the long-term goals of the MFIs and our own mission, we do not intend to draw dividends but instead aim to capitalize MFIs well and aim for a healthy but fair return over the life of the fund (Agora).*

> *Interest rates reflect the philanthropic nature of the DB MDF. In the case of loans, the interest income earned on the deposit is retained by the microfinance institution, offsetting some or all of the interest expense of the loan (Dutch Bank Microcredit Development Fund)*

Funds which provided both equity and debt financing set a specific boundary on their investment in MFIs, aiming to produce a target income either from capital investment or from lending interest, in order to increase the current value of their investment portfolio. In fact, "*Dutch Microfund invests around 50% on loan and 50% on equity. The loan vehicle receives 3% to 6% and equity vehicle generates 10% to 20% due to the average financial leverage on equity side about 3.5 times, so the overall estimated return of DMF is 6.5% to 13%*'".

From this data, we can assume that the investment returns of microfinance funds are likely dependent on the quality of invested MFIs, and their ability to provide and collect loans with promising earnings from interest rates. Some funds (i.e. Dual Return Fund, Dutch MicroFund) stated their invested MFIs had high repayment rate, ranging from 95% to 100%. Also, the interest paid from micro borrowers, particularly local entrepreneurs in developing countries, potentially enable MFIs to generate profit and further self-financing to repay loans and to earn a return for capital invested from microfinance funds. Interest rates that MFIs charged to their borrowers on average ranged from 15% to 35% per month, higher than domestic commercial banks, relying on local market rates and regional distribution to sufficiently cover their high transaction costs on small loan amounts. Hence, collection and default rates are crucial factors influencing the investment decision making of funds.

> *Its on-going profit stream will comprise of (i) interests from loans extended to MFIs and, to a lesser extent, of (ii) dividends from equity shareholdings. The Investment Fund's prime objective is to generate a solid recurrent annual flow of income from interests and dividends, out of which Impulse will finance an annual pay-out to its Shareholders (Incofin-Impulse Microfinance Fund).*

5.1.9 Hedging, Leverage and Exit Strategy

Hedging

Thirteen funds mentioned currency hedging. Currency risk is one of potential risks for MFIs, which may lead to enormous losses for both institutions and microfinance funds, so hedging mechanisms are needed where there is lending in foreign currency. See the detailed discussion in the previous section: 5.1.8.

Leverage

Leverage context appeared on ten fund websites. Generally this was a discussion about the ability to access to private capital by leveraging public funds from donors or development agencies, as a risk-cushion to secure and attract more financing sources from private investors (socially motivated individual and institutional investors), and to enable them to run with a stable source of capital. The innovation of structured products to meet the particular needs of investors is another example of leveraged capital. For instance, the junior tranche is often subscribed by public investors acting as a financial cushion that provides greater support to commercial investors to invest in the senior tranche. Most of the ten funds said they had succeeded in using leveraging to increase resources for expanding geographic scope and product delivery, and for continued extension of the positive impact for MFI beneficiaries, including social and environmental values.

> *EFSE leverages the impact of scarce budget funds and at the same time opens the gateway for private capital investments to the countries in Southeast Europe, including the European Eastern Neighborhood Region.*

Exit Strategy

Five (10%) out of the 47 funds who made equity investment presented an exit strategy, but without an adequate description. Among those, some talked of exit after enhancing value in MFIs (AfriCap) or after invested institutions become financial sustainability and able to get loans from capital market (Hivos-Triodos) or on the appearance of another lender who can carry on the role when latter withdrawal (I&P). Some funds (DID-Fonidi and Incofin-Impulse) aimed to sell a part of their shares at the end of the term through put-options in private contracts, which facilitated the desired timing of exit, the predetermined price and towards a predetermined purchasing entity. Theoretically, exit is the most critical stage for equity funds and venture capital as it requires time and resources (Köhn & Jainzik, 2007) and is one risk in equity funding (Biallas & Schwiete, 2006). Put options are the most commonly used exit strategy, selling out equity positions. Exit prices usually depend on the performance of the MFI (Maier & Pischke, 2008).

5.2 Statistical Test of Categories

Many researchers agree good content analysis should be also quantitative, because the results of data can be counted and analyzed using statistic techniques (Holdford, 2008). Category data from this study can be expressed in a contingency table that makes it possible to further determine whether there is any significant association between any two categories identified. Principally, Chi-square (χ^2) technique become the most useful when analyzing cross tabulation. χ^2 does not give any information about the strength of the relationship between categories: it can only show the existence or nonexistence of a relationship, a "yes" or a "no" for the categories or variables investigated.

Starting with the assumption of a Null hypothesis (H_0) states two variables are not related. If P-value of calculation is bigger than the significant level 0.05, accept (H_0), otherwise reject when P-value is less than 0.05. This can be expressed in the formula:

$$\chi^2 = \frac{\sum(O-E)^2}{E} \quad (O = \text{Observation}, E = \text{Expected value})$$

Our study focused on the particular components which form a well designed investment strategy for a microfinance investment fund, where the most necessary components are funding tools and type of currency used to invest. In this study χ^2 was used to test independence, to identify whether the financing instrument is related to eligible partners by development stage. Also, to test if there is association between financing instruments with the currency of the investment. Moreover, we also want to determine the relationship between investor types and the financing instrument of microfinance funds. This leads to propositions such as: firstly, types of financing instruments offered by microfinance funds are related to the type of MFIs; secondly, the currency used is linked with the financing instruments used; lastly, types of investor will have more reference to the type of financing instrument of microfinance investment funds. These propositions add up to the following *Hypothesis*:

- (H_0): Financing instruments and eligible partners are independent.
- (H_0): Financing instruments and currency are independent.
- (H_0): Types of investor are not associated with types of financing instruments.

Table 5.10 analyzes the investigated categories by testing the number of presences and absences of those categories, using a series of chi-square tests. We compared the observed occurrences for each pair of category, e.g. loan guarantee versus start-up, loan guarantee versus expansion, to find the significant values which enable us to draw a conclusion from this statistical test. Based on the result of chi-square tests, there is a weak confirmation to reject the above hypothesis: that the investigated categories are not related. From this test result, we can conclude that the decision of microfinance funds to invest in MFIs through a specific vehicle such as equity or debt or loan guarantee is not attributed by the type of institution. There are no conditions on which types of instrument will be financed by a particular institution. Similarly, investment made in either local or foreign currency is disassociated from the financing instrument. Moreover, investors who choose to finance microfinance funds are not influenced by the type of financing instruments that this organization is providing to MFIs.

The conclusion from this finding is not compatible with the existing literature of microfinance, which holds that funding tools vary by the development stage of microfinance service providers. Typically, equity financing or grants are offered at the early stage of MFIs to support regulatory requirements, start-up costs, infrastructure, and capacity building, while debt financing extends to lending for portfolio growth of mature, profitable institutions (Ledgerwood, 2012). So the difference of this finding with previous ones does not mean the finding is incorrect because, as the result can be attributed to the sample size of study, especially where what is stated in the literature refers to the funding tools of all investors in microfinance, not the tools provided by investment funds. The association between currency and financing instruments, investor types and financing tools of microfinance funds would be kept for future study, either in quantitative or qualitative technique, since there is no relevant previous study on these contexts.

Table 5.10: Statistical Test on Categories

		(1)		(2)		(3)		(4)	
		Guarantee		Equity		Loan		Others	
		No	Yes	No	Yes	No	Yes	No	Yes
Development stage of microfinance									
Start-up	No	38	17	28	27	10	45	42	13
	Yes	21	8	9	20	12	17	19	10
	χ^2	2.36		3.04		5.29		1.12	
	p-value	0.12		0.08		0.02		0.28	
Expansion	No	36	17	24	29	13	40	38	15
	Yes	23	8	13	18	9	22	23	8
	χ^2	0.37		0.09		0.20		0.06	
	p-value	0.54		0.76		0.65		0.80	
Mature	No	46	13	31	38	20	49	49	20
	Yes	23	2	6	9	2	13	12	3
	χ^2	0.10		0.12		1.56		0.50	
	p-value	0.75		0.73		0.21		0.48	

Continued on next page

Table 5.10 Continued from previous page

		(1) Guarantee		(2) Equity		(3) Loan		(4) Others	
		No	Yes	No	Yes	No	Yes	No	Yes
Currency made in investment									
Foreign	No	39	12	24	27	20	31	37	14
	Yes	20	13	13	20	2	31	24	9
	χ^2	2.41		0.48		11.39		3e-04	
	p-value	0.12		0.49		0.00		0.98	
Local	No	41	12	25	28	17	36	43	10
	Yes	18	13	12	19	5	26	18	13
	χ^2	3.48		0.57		2.57		5.23	
	p-value	0.06		0.45		0.11		0.02	

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Table 5.10 Continued from previous page

		(1)		(2)		(3)		(4)	
		Guarantee		Equity		Loan		Others	
		No	Yes	No	Yes	No	Yes	No	Yes
Type of investor									
Fund of fund	No	46	20	28	38	19	47	47	19
	Yes	13	5	9	9	3	15	14	4
	χ^2	0.04		0.33		0.66		0.31	
	p-value	0.83		0.56		0.42		0.58	
Institutional	No	25	13	18	20	11	27	27	11
	Yes	34	12	19	27	11	35	34	12
	χ^2	0.66		0.31		0.27		0.08	
	p-value	0.42		0.58		0.6		0.77	
Donor	No	48	15	23	40	18	45	47	16
	Yes	11	10	14	7	4	17	14	7
	χ^2	4.27		5.81		0.74		0.5	
	p-value	0.04		0.01		0.39		0.48	
Individual	No	34	14	24	24	12	36	33	15
	Yes	25	11	13	23	10	26	28	8
	χ^2	0.02		1.61		0.08		0.84	
	p-value	0.9		0.2		0.77		0.36	
Public	No	41	16	26	31	12	45	43	14
	Yes	18	9	11	16	10	17	18	9
	χ^2	0.24		0.18		2.44		0.71	
	p-value	0.62		0.67		0.11		0.4	

Concluded

5.3 Summary of Significant Finding

This thesis is of an exploratory nature, aiming to determine and describe related information gleaned from the websites of microfinance investment funds. The main research question was expanded by sub-questions, which were raised in section: 4.1. The significant findings which answer the sub-questions were found in section: 5.1 and can be summarized in the following Table: 5.11. More importantly, this summary of finding relates to the main objective of this thesis: the intention to the identify particular components which are part of formulation of microfinance investment fund investment strategies, which is very functional knowledge for all relevant parties.

Table 5.11: Summary of Significant Finding

Findings	Discussion with prior studies
1) **Objective of investment in microfinance**:	
Several purposes were found, but the most frequently referenced were to contribute towards economic development (poverty alleviation focus), to bring about affordable financial services to beneficiaries, to channel capital to MFIs, and a double bottom line objective. In short, investment striving for an affirmative social impact on wider society, and financial returns to the shareholders of funds. Meanwhile, some funds extended their objective to a triple bottom line which also included an environmental focus over and above the double line objective.	The investment objective found in this study is parallel with the MFIs,' as MFIs mainly work for social development while earning financial return for investors. Funds work as financial intermediaries between investor and MFI, attempting to make financial resources available for both MFIs and ultimate beneficiaries, helping them to raise their living standards. In return, a significant value may be added to their current portfolio investments. Furthermore, the triple objectives with which both MFIs and microfinance funds operate in social and environment aspects, and financial gain basis, are increasingly important. More and more MFIs concentrate on the environment because of their concern about the ability to create profit.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
2) **Investment eligible criteria:**	
- Age of MFIs operation or minimum track record: between 1 to 3 years depending on the objective of funds. - Minimum existing total asset or capital: ranged from US$50,000 up to US$2 million depending on the size of institutions, location, and financing instruments. - Country context and legal status - Social mission criterion - Loan portfolio and Financial quality - Management quality - Operation and Outreach quality - Investors' interests	What is interesting is the number of microfinance funds that presented each criterion was small, even though it is recognized as crucial element to in guiding fund managers in investment decision making. Less than 40% of total funds showed any of these investment criteria on their websites. Where they did, they mainly focused on institutional quality and social mission criteria. The set of social mission in selection criteria is a unique characteristic of investment in microfinance. The age, the total asset/capital and the country context were mentioned by very few, while theoretically they play a vital role in investment decisions. There is no literature or earlier studies of investment criteria of microfinance investment funds, so we had no guidance to examine this finding to see whether its components are sufficient or not. However, we could discuss individually each criterion by comparing to the related previous studies.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
3) **Investment sector (The eligible partners)**: - *By tier*: Tier 1, Tier 2, Tier 3 - *By development stage of MFI*: Emerging stage (small, start-up MFIs); Expansion stage (mid-size, growth-oriented MFIs); Mature stage (Large, sustainable MFIs) - *By charter*: Development bank, commercial bank, NBFI, other investment fund, technology company, housing developer, leasing company, NGOs, credit union/cooperative, microlending company, SMEs, and fair trade. Microfinance funds in this study targeted largely at the expansion stage or can be called a mid-size, growth-oriented MFI. Formal institutions were dominant, while informal institutions were not found to be a target of microfinance funds.	The major investment is in the expansion stage of profitable MFIs, reflecting microfinance funds' target for financial return from their investments, despite their social orientation. Meanwhile, financing in the start-up stage is principally funded by donors or development agencies. Some funds targeted the eligible partners beyond microfinance, extending into contiguous fields like SMEs and fair trade. This finding corresponded to the report of CGAP in 2012 which announced that some large funds such as Oxfam, Symbiotic, ACCION are providing financial access not only through microfinance, but also through a variety of sectors, including agriculture, technology, energy, housing, and small enterprises. However, this diversification brings a fear that the objective of microfinance funds, the investment in microfinance, will be modified, and this will channel funding away from such funds.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
4) **Financing Instrument Characteristics (Key products and its terms offered to MFIs):**	
- *Financing Instruments*: Considerable financing in loan/debt instrument, equity, and loan guarantee. Other financing types included grants, quasi-equity or convertible loans, term deposits, and technical assistance. Debt investment was dominant, and often financed in the expansion and mature stage of an MFI or in any service providers categorized as semi-formal institutions, followed by equity, which made investment primarily in the emerging stage of an MFI or in any service providers classified into formal institutions. - *Maturity:* The length of financing in debt and in loan guarantees was similar, ranged from one to five years, while equity financing was longer term, up to 10 years but not over 15 years. Term deposits are provided for not longer than 12 months.	The findings on financing instrument in this study confirms previous studies that often found debt investment is prevalent. Investment in either debt or both debt and equity has the intention to diversify risk and to increase the value of portfolio, as well as funding portfolio growth or to refinance the maturing debt of invested MFIs, while equity investment seeks to hold a minor share of potential MFIs (Ledgerwood, 2012). Correspondingly, debt investment focuses on the expansion and the mature stages, where MFIs is approaching or achieving profitability, with equity financing in early stage MFIs to support start-up costs and regulatory requirements, and to secure the lender for lending to MFIs. It is notable that the new sectors such as SMEs and fair trade, which microfinance funds expanded to finance, were mostly made in equity which has a longer investment horizon for returns.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
- *Financing size*: Debt investment ranged from US1$toUS$3 million, while equity investment is made based on the existing capital or total assets of a qualified MFI, and is restricted to not exceeding 30% of total assets. *Currency:* Some funds finance solely in local or foreign currency, while others provide both types, adapting to the needs of the MFI. Foreign currency can be made on the availability of hedging mechanisms. - *Collateral*: Some funds require adequate collateral, others do not, as investing in recourse obligation. Financing in loan guarantees oblige MFIs to guarantee a partial amount of accessing loan as collateral. - *Date of payment:* MFIs can pay installments quarterly or semi-annually, the interest alone or interest plus a portion of the principal.	The characteristics of each funding tool type were hardly discussed, in less than 50% of the studied funds, it seems it is not essential to inform stakeholders. The length of debt investment in previous studies was three or four years at most, which is slightly different from this study, where large funds had a maximum of five or seven years. Even though not many funds discussed currency of an investment, there were more incidences of foreign currency, which matches the literature. Also, the occurrence of funds providing local currency is also remarkable, proving that funds put more consideration into financing in local currency in order to prevent MFIs from loss through foreign exchange exposure.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
5) **Funding sources of microfinance funds:** - *Funding structure*: Financial products proposed to investors on equity and debt basis, such as preferred stock or common stock, junior debt, subordinated debt or senior debt. Its terms include interest and date of payment, and management fee. Funds have developed through innovation a variety of financial products with various forms and delivery channels, with the aim of responding to the overall investment fund objectives and the needs of a wide range of investors. Interest rates can be charged based on the amount, distribution channel, tenure, and terms of financial products. The annual fee for fund management ranged from 2.2% to 4%. - *Types of investor*: Institutional investors were dominant, followed by individual investors, public investors, private donors, and funds of funds.	We found very few funds (12%) displayed their financial products, and less than 5% revealed about their terms on their websites. There was a noticeable lack of clarity and detail, for example, the messages did not show on what basis management fees are charged, however it may be detailed in the prospectus of the funds. This finding agrees with earlier studies that microfinance funds are financed chiefly by private investors, mainly from institutional investors who basically need a financial return while a social return is complimentary. This may create the assumption that an MFI cannot succeed unless it can achieve both social development and financial return for their investors. The priority of financial performance from private investors seemingly affects the investment decisions of microfinance funds.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
6) **Geographic distribution of microfinance investment:** Asia, Africa, Latin America and Caribbean, Eastern Europe and Central Asia, Southeast Europe, worldwide. Asia and Africa was widely represented, followed by LAC, ECA and other regions. Some funds spoke of financing MFIs all over the world, not only the ones in regions they are currently active in.	The high representation of Asia and Africa in this study confirms with prior studies, that increasing numbers of private investors and uninvested capital have prompted fund managers to diversify their services into new regions where is rapid increase in microfinance demands, mostly located in Asia and Africa. However, there is also concern about about over-indebtedness of microfinance clients where the management quality of MFIs in those region is limited.
7) **Risk and Return:** - *Risk and its mitigation*: The two main associated risks of studied funds were currency risk and credit risk. Currency risk comes from investment made in foreign currency. Funds could prevent this kind of risk by strictly	It is noticeable that fewer than 50% of studied funds talked about risk and return on their websites. Funds seemingly did not give much attention to it, or it is not necessary to inform the public. However, it is a powerful determinant in investment decision

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
financial analyzing and using currency swap instrument or engaging with third party interventions. Funds would share a loss from foreign exchange risk with the MFIs or with particular investors. Credit risk could be protected through internal ratings to examine the capacity and the management quality of MFIs, and ongoing monitoring of MFI operation (refer to the 2^{nd} and 6^{th} step of investment selection process). Some funds created watch lists to determine vulnerable areas and potential issues. Still, funds need to purchase insurance to secure their investments as uncontrollable risk is unavoidable. - *Return*: Most funds declared they would provide financial returns near or slightly above money market interest rates in either US dollars or Euros, while very few funds proposed below market rate or lower than other assets in capital markets, as they more focus on social objectives. The interest rates on loan lending may vary in the	making as fund managers have to consider relevant risk and expected return for investors. Loan quality (high repayment, low default rate, and high interest rate) of MFIs was also mentioned as a motivation for a microfinance fund to make an investment, and as such is a factor determining investment return of the funds. In fact, not only loan quality but also currency lending, benchmark yields and pricing, the length of investment, risk appraisal, and financing instruments are means to achieve the expected return. Mention of the characteristics of currency risk and credit risk on websites included little detail, but was similar to a large part of the relevant literature. Particularly, funds argued that risks can be spread out through diversification of investments, which add value to fund portfolio assets and decrease asset volatility. Most funds displayed their returns on their website in descriptive sentences, not in specific rates. Also, common return on debt

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
development stage of MFI, depending on cash flow and the proportion of loans in the capital structure of the MFI. We found debt financing yielded between 2.6% to 5.1% in US dollars. Equity financing has not yet generated significant return to investors, despite some leading MFIs showing very good return on equity.	investment from this study is inconsistent with previous studies, which found rate a decline from 5% to around 2.5% in 2011 while equity financing is still insignificant.
8) **Hedging:** This refers to currency hedging mechanism, once foreign currency financing is made. As already discussed in section: mitigation of currency risk, funds often use currency swap instrument and insurance companies. More importantly, funds believe that sufficient international diversification investment is also a means to hedge currency exposure.	Currency Hedging is an insurance policy to protect investment return from foreign exchange losses. It can be made through back-to-back lending, forward contracts, partial credit, currency swaps and third party interventions.

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
9) **Leverage:** Very few funds talked about leverage on their websites. Some mentioned the success of raising capital through leveraging public funds from donors and development agencies to secure and attract financing from private investors.	In general, leverage refers to the comparison of owner's capital to the borrowing funds. Website information did not refer to specific maximum leverage ratios, where funds are allowed to borrow to leverage investor capital.
10) **Exit strategy:** Funds financing in equity attempt to exit in different circumstances. They want to exit after an invested MFI has increased its value, become financially sustainable or able to access credit from capital market, or once another lender has replaced the funds' role. Some funds wished to sell a part of their shares at the end of term through put-options in private contracts which predetermined the desired exit time, the prices, and the purchaser	Only 10% of 47 funds displayed the their exit strategy, with a lack of detail, despite this being an essential consideration for potential investors, and a factor that funds need to scrutinize in order to get a successful return when exiting. Exit strategy requires time and resources at the leaving stage, and funds may face of losses if employing the wrong one. Put options are the most common strategy for exit by selling out the equity positions. Exit prices often rely on the performance of the MFI

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Table 5.11 Continued from previous page

Findings	Discussion with prior studies
11)**Process of investment selection:** There are six sequential steps: - 1^{st} Screening and Identifying the eligible partner - 2^{nd} Market survey/Investment analysis - 3^{rd} Due diligence - 4^{th}Investment approval/disbursement - 5^{th} Reporting - 6^{th} Ongoing monitoring	see detailed explanation on each step in Figure: 5.2. There is no existing literature on microfinance to validate this finding. However, we can see this process is not far different from the investment process of other funds, e.g. mutual funds.

Concluded

Chapter 6

Conclusion

6.1 Conclusion

This research aimed to identify and describe a wide range of information regarding the investment strategies of microfinance investment funds through investigation of 84 microfinance investment funds listed in MIX market. The data studied was written information collected from websites of those 84 funds. The problem statement indicated that insufficient comprehensive information on the investment conditions of microfinance investment funds may have a negative impact on the growth of the microfinance sector, as investors may make incorrect decisions in investment allocation, while MFIs may be frustrated in gaining access to funding. The main question of this research is *how are the investment strategies of microfinance investment funds designed*? The answer will better inform stakeholders and promote more finance in microfinance. Ten sub-questions were developed to respond to this research question, and the answers are found in chapter: 5 which are summarized in Table: 5.11; coming to the conclusion that follows.

This study has found that the purpose of microfinance investment funds in investing in microfinance is parallel with the MFIs' objective, an attempt to create a significant financial return to shareholders while seeking to have a positive impact on society. In addition, some funds also strive for the triple-bottom line objective, which emphasizes not only social and financial value but also environmental value, in order to avoid impeding the success of the microfinance sector. Selection criteria for investment, known to be an important guidance for investment decision making, was confirmed as a component of investment strategy. This refers to a number of internal criteria that applicant institutions need to meet if they want to get financing, such as the length of an MFI's operation, the minimum amount of existing assets or capital, the country context and legal forms, social mission criteria, loan portfolio and financial quality, operation and outreach quality and management quality. Different funds have established different investment conditions, however, their criteria generally focus on institutional quality and social mission requirements. The essential requirement of a social mission is a unique characteristic of investment in microfinance, reflecting that social impact have influence on their investment decision.

Microfinance investment funds target formal and semi-formal institutions that provide microfinance services to ultimate beneficiaries. Funds finance largely in MFIs in their expansion stage (mid-sized, growth-oriented MFIs), followed in volume of financing by the emerging stage and finally the mature stage. Microfinance funds provide financing not only to MFIs but also have begun to extend into related and relevant sectors, such as SMEs, fair trade, and associated producers, corresponding to the recent CGAP report that some large MIVs are broadening financial access through other avenues, including agriculture, small enterprises, education, energy, and housing (Moretto & Glisovic, 2012). Moreover, other quantitative studies have similar findings on financing instruments, that investment in loan or debt instruments are dominant, followed by equity investment and loan guarantees. Other tools such as quasi-equity or convertible loans, term deposits, grants and financing by technical assistance are also used. Loan investment is primarily offered for the expansion and mature stage, to support portfolio growth and to relend. Funds innovate loan products to meet the specific need of MFIs, attempting to add value in the investment portfolio and to spread out potential risk, acknowledging existing literature that confirms investment in microfinance can reduce portfolio volatility.

Equity investment is made chiefly at the emerging stage of an MFI, and intends to obtain a minor stake in capital, while loan guarantees aims to bridge MFIs to get a required funding from local commercial banks. There is a limitation of asset allocation in the case of diversified financing or mix-financing, in order to get an expected return from their portfolio investment. Remarkably, the diversification into new sectors is made in capital investment. Not many microfinance funds displayed the characteristics of each financing instrument type, including their maturity, size, currency, collateral, and date of repayment. We found investment offered in foreign currency is prevalent, and most of funds stretch to provide local currency where hedging mechanisms are available. Although funds know collateral is difficult for MFIs, some funds still require securing the inherent risk from capital investment. Furthermore, this contextual study is in line with earlier quantitative studies, finding that the main investors of microfinance funds are private sector investors, extensively represented by institutional investors. The increased involvement of institutional investors has a big influence on investment decision making, which may lead microfinance funds to emphasize financial performance for the superior return to such investors.

The majority of microfinance funds invested in Asia and Africa, followed by LAC, EAC and other regions. This finding is consistent with the relevant literature, which mentioned that fund managers are extending investment into new regions where there is a high demand for microfinance; most of those countries are in Asia and Africa. The growth rate of both regions is constantly increasing, while in LAC and EAC was noticeably declining (Symbiotics, 2011). The categories of risk and return are also revealed in this research. Microfinance funds generally talked about the risk profile in microfinance institutions since they saw that the risk of their investment is caused from the coherent risk in MFIs. There are currency risks and credit risks. Funds presented mechanisms to protect and reduce relevant risk from their investment, including currency swaps and third party interventions, building sufficient international diversification (for foreign exchange exposure), and rigidly examining and analyzing applicant organizations by looking at the established investment criteria and following the process of investment (see Figure: 5.2). Essentially, funds believe that diversification of investment into wider and more diversified MFIs will reduce risk and strengthen portfolio assets. The high quality of micro-loans come from high repayment and low default rates, and high repayment rate for originators of the investment return are incentives for microfinance funds. Some funds proposed provision of returns at slightly above or equal to money market rates, while some offer at below market rate or lower than other assets in capital market since they are more social oriented. Different funds showed return from debt investments differently. Also, interest rates varied for different development stages of an MFI. Common rates of return from debt financing ranged from 2.6% to 5.1% in US dollars. Equity financing was declared not to provide significant return to investor of the funds; dividends are reinvested, even where some advanced MFIs showed a very good return on equity.

This research also investigated whether exit strategy, leverage and hedging are discussed or not. We found very few funds, less than 15% of the total, talked about these categories in briefly. Funds that made investment in equity aim to exit once the invested MFIs are able to access credit from capital markets, or when they become financially sustainable, or after adding value to MFIs, or when another investor replaces the role of the microfinance fund. Some funds plan to sell a part of share at maturity through put-options in private contracts, which predefine the exit time, prices and purchasing entity. Rather than showing the maximum allowed leverage ratio, funds told the success of capital raising through leveraging public funds from donors and development agencies, as a financial cushion to secure and attract financing from private investors. Finally, we found the process of investment selection to be an essential part of investment strategy, the procedure that a fund manager needs to follow in order to make an investment. Six sequential stages were found, from identifying potential investments, market surveys and investment analysis, due diligence and review, investment approval and loan disbursement, reporting, and the ongoing monitoring stage (see the Figure: 5.2). Each stage requires time and resources in order to make a right decision on choosing to invest in any qualified partners.

So we can conclude that the main components of the investment strategy of a microfinance fund include investment objective, investment eligibility criteria, investment sector or eligible partners, financing instruments and their terms, risk, return, leverage, hedging, exit strategy, and investment procedure. The elements of each component of investment strategy are listed in the summary finding Table: 5.11. This research has generated a finding which is scarcely documented in the existing literature, applying the new technique of analysis in microfinance sector. As a result this research will benefit microfinance funds, investors and MFIs to better know what the investment strategy of fund looks like, and better understand the investment behavior and condition of microfinance funds. The answers to each sub-question are consistent with the existing literature or previous studies, even though the entire structure of investment strategy cannot be validated with the previous ones.

6.2 Contribution of this Research

As already mentioned in section: 1.2, the information related to microfinance investment funds is rarely publicly accessible, and the previous studies have focused on performance evaluation and mostly applied quantitative analysis. Contextual study has been considered less, and has not been used to investigate the investment strategy of microfinance funds. These findings, importantly, discover new structures in investment strategy, and so this research significantly contributes to the literature and practicality of microfinance investment. Both investors and MFIs can take advantage of these findings for a clearer insight into the microfinance investment situation.

For investors, better understanding of the objectives, behaviors, conditions, and procedures of microfinance funds in selecting investment in microfinance can assist investors to choose funds which satisfy their preferences. Similarly, microfinance institutions can prepare themselves before attempting to access financing from microfinance funds, through improved comprehension of what criteria microfinance funds require, and to evaluate areas of weakness. Moreover, this finding also an asset for microfinance funds, showing a pattern of information related to investment that should be presented on websites to better inform to stakeholders. Finally, the design of investment strategies can be documented as a model, contributing to microfinance literature for future study, with application across various methodologies, leading to deeper understanding and the discovery of unexpected elements or patterns which can be very useful for investors and investment funds in decision making.

6.3 Limitation

The aim of this research was to ensure that findings could be generalized, however due to the lack of accessible data and resources, the study was limited to written text on fund websites regarding investment strategies. The analysis was limited to qualitative content technique of an exploratory nature to find out the particular components of investment strategy. The main components of investment strategy were uncovered, but the information was not elaborate, uniform, or systematic, and in particular the ignorance the size of studied funds in discussion, despite the knowledge that different fund sizes have different operations, objectives, and strategies. Therefore result can be strictly generalizable only to on-line information, and cannot represent the investment strategy of microfinance as a whole.

Secondly, the collected data is possibly not deep enough, and is insufficiently meaningful in attempting to capture the entire universe of the strategy of microfinance funds. Some relevant information such as management fees, interest charges, types of return, types of financial products that investors mostly prefer and yield of distribution, were not available, so some analysis could not be applied, and some findings could not be compared with earlier studies. Again it must be emphasized that only written text on the websites of microfinance funds was examined, so the findings are based on a perception of microfinance investment funds without any reference to MFIs or investors. However, the study was not excessively limited by the lack of such data because the main aim of the study was to understand the structure of investment strategy from the perspective of the microfinance fund for which information was readily available.

Thirdly, there is no previous study or existing relevant literature of investment strategy of microfinance investment fund since these funds are recognized as new, and emerging, and most of previous studies have concentrated on an evaluation of financial performance through quantitative techniques. A causal link between categories could not be established precisely, and the completed findings could not be validated against previous ones, but each component, such as type of investor, financing instrument, geographic distribution, objective of investment was individually discussed and observed where prior studies using those statistical technique were applied, or with the appropriate theories. Additionally, the sub-research questions were formulated depending on initial readings of the collected data and on the MIV disclosure for investor reporting basis (see Appendix C)[43]. The model or the structure developed therefore suffers from this limitation. Finally, due to limited time and information, this study could not investigate deeply the technical assistance, which is one element of investment strategy.

6.4 Further Research

The contextual and comprehensive study of microfinance fund's investment strategy from online-information appears to be a new method of researching in microfinance. Further studies should be in aggregate level, employing greater materials of study, such as internal official documents, annual reports, and interviews, to put more emphasis on other relevant investment characteristics, such as their strength, weakness, and structure breaks; to examine how this affects investment performance and the behavior of the fund manager; and to assess the impact of investment strategies on fund manager decision making, as well as on the behavior of investors and MFIs. Next, the study of investment strategy of microfinance funds combines with the examination of specific

[43] According to "Microfinance Investment Vehicle Disclosure Guidelines" produced by CGAP in 2010 with the aim of establishing clear guidelines for MIVs reporting to investors

financial needs and management capacities of MFIs, to arrive at better designed investment strategies and a better understanding of what will be successful in providing financial access to microfinance institutions.

Thirdly, technical assistance is a crucial means of support for the development of MFIs, that microfinance funds usually provide along with the financing; it is also a component of investment strategy of microfinance investment funds. Further study of investment funds is needed to highlight to what extent that technical assistance influences or interferes with investment decisions, what basic forms this technical support takes, and the roles and conditions involved in providing such support. Lastly, further research can engage in investigating the behavior of microfinance fund investors to see what influences their investment decisions. This study showed that much information about microfinance funds is not publicly revealed. For instance, there was no information on funding structure of funds (financial products that investors mostly finance) nor the detailed investment return, investment size and tenures, to enable the comparison of microfinance funds investment with other assets investment in the market. Consequently, investors are likely to be ill informed, which may lead them to inefficient decision making.

Appendix A

Microfinance Investment Fund List

Table A.1: List of Microfinance Investment Funds

No.	Name	Website	Country
1	Aavishkaar Goodwell	www.aavishkaargoodwell.com	India
2	AccessHolding	www.accessholding.com	Germany
ACCION		www.accion.org	United States
3	Accion Gateway Fund	www.accion.org	United States
4	ACCION Global Bridge Fund	www.accion.org	United States
5	ACCION Investments in	www.accion.org	United States
6	ACCION-Latin America Bridge Fund (LABF)	www.accion.org	United States
7	Advans SA	www.advansgroup.com	Luxembourg
8	AfriCap	www.africapfund.com	Mauritius
9	Agora Microfinance Partners LLP	www.agoramicrofinance.com	United Kingdom
10	Ambers Microfinanzas	www.amberscocapital.com	Spain
11	ASN-Novib Micro-kredietfonds	www.asnbank.nl	Netherlands
12	Bellwether	www.bellwetherfund.com	India
13	BISMA	Indonesia	
14	Dexia Microcredit Fund	www.blueorchard.com	Switzerland
15	MICrofinance Enhancement	www.blueorchard.com	Switzerland
16	Microfinance Growth Facility	www.blueorchard.com	Switzerland
BlueOrchard		www.blueorchard.com	Switzerland
17	BlueOrchard Private Equity Fund	www.blueorchard.com	Switzerland
18	BOLD 2006-1	www.blueorchard.com	Switzerland
19	BOLD 2007-1	www.blueorchard.com	Switzerland
20	BOMS1	www.blueorchard.com	Switzerland
21	Calvert Foundation	www.calvertfoundation.org	United States
22	Community Needs	www.capitalforcommunities.	United States

No.	Name	Website	Country
CASPIAN		www.caspian.in	India
23	Creation Investments Social Ventures Fund I	http:creationinvestment..	United States
24	CRESUD	www.cresud.it	Italy
Dutch Bank		www.db.com/usa/content/en	United States
25	DB Start up	www.db.com/usa/content/en	United States
26	DB-FINCA Microfinance Fund	www.db.com/usa/content/en	United States
27	DBMDF	www.db.com/usa/content/en	United States
28	DB-The Global Commercial Microfinance Consortium	www.db.com/usa/content/en	United States
29	DID	www.did.qc.ca	Canada
30	Dignity Fund, L.P.	www.dignityfund.com	United States
31	Dual Return Fund	www.visionmicrofinance.co...	Austria
32	Dutch Microfund	www.annexum.nl/nl/dutch_microfund	Netherlands
33	EFSE	www.efse.lu	Luxembourg
34	Elevar Equity II	www.elevarequity.com	United States
35	Envest	www.envestmicrofinance.org	United States
36	FIG	www.fig-igf.org	Switzerland
37	FPM	http://www.fpm.cd/	Congo
38	FRONTIERS	www.frontiers.kg	Kyrgyzstan
39	Global Partnerships Microfinance Fund	www.globalpartnerships.or...	United States
40	Goodwell	www.goodwell.nl	Netherlands
41	Grameen Credit Agricole Microfinance Foundation	www.grameen-credit-agrico...	Luxembourg
42	Gray Ghost	www.grayghostfund.com	United States
43	Hivos-Triodos Fund	www.triodos.com/microfina...	Netherlands
44	I&P Developpement	www.ip-dev.com	France
45	IFIF	www.caspian.in	India
46	IFMR Capital	http://capital.ifmr.co.in/	India
47	Incofin-mpulse Microfinance Investment Fund	www.incofin.be	Belgium
48	Incofin IM	www.incofin.be/en/mfi.htm...	Belgium
49	Incofin-CVSO	www.incofin.be	Belgium
50	Incofin-Rural Impulse Fund I	www.incofin.be	Belgium
51	Incofin-Rural Impulse Fund II	www.incofin.be	Belgium
52	Incofin-VDK Loan Portfolio	www.incofin.be	Belgium
53	JAIDA	www.jaida.ma	Morocco
54	Kolibri Kapital ASA	www.kolibrikapital.no	Norway
55	LMDF	www.lmdf.lu	Luxembourg
56	Locfund	www.locfund.com	Bolivia
57	Lok Capital	www.lokcapital.com	India

No.	Name	Website	Country
58	MicroCred	www.microcredgroup.com/	France
59	MicroCredit Enterprises	www.MCEnterprises.org	United States
60	MicroVentures Luxembourg	www.micro-ventures.com	Luxembourg
61	MicroVest	www.microvestfund.com	United States
62	Minlam Microfinance Fund	www.minlam.com	United States
63	NMI Global fund	www.nmimicro.no/	Norway
64	NMI Frontier Fund	www.nmimicro.no/	Norway
65	Oikocredit	www.oikocredit.org	Netherlands
66	Omidyar LLC	www.omidyar.net	United States
67	Oxfam Novib Fund	www.triplejump.eu	Netherlands
68	Oxfam Triple Jump	ww.triplejump.eu/	Netherlands
69	Partners for the Common Good	www.pcgloanfund.org	United States
70	PlaNet MicroFund	www.planetfinance.org	France
71	REGMIFA	http://www.regmifa.com/	Luxembourg
72	ResponsAbility BOP Investments	www.responsability.com	Switzerland
73	ResponsAbility Global Microfinance Fund	www.responsAbility.com	Switzerland
74	ResponsAbility Microfinance Leaders Fund	www.responsAbility.com	Switzerland
ResponsAbility		www.responsAbility.com	Switzerland
75	ResponsAbility Mikrofinanz-Fonds	www.responsability.com	Switzerland
76	Riskebiz Microfinance Fund	www.riskebiz.com	Canada
77	SCDF	www.seed-capital.org	United States
78	SIDI	www.sidi.fr	France
79	Terrafina Microfinance	www.terrafina.nl	Netherlands
80	Triodos Fair Share Fund	www.triodos.com/microfina...	Netherlands
81	Triodos Microfinance Fund	www.triodos.com/microfina...	Netherlands
Triodos		www.triodos.com/microfina...	Netherlands
82	Unitus Equity Fund I	www.elevarequity.com	United States
83	USAID Credit Guarantees	www.usaid.gov/our_work/ec...	United States
84	Vision Fund	www.visionfundinternation...	United States

Appendix B

Tree Nodes

1. Investment selection criteria

Type	Name		Sources
	Age of MFI operation		10
	Base on Investors' interests		1
	Country context and legal status		10
	Geography focus		0
	Type	Name	Sources
		Africa	46
		America	15
		Asia	49
		Eastern Europe and Central Asia	27
		Latin America and Caribbean	36
		Sotheast Europe	4
		Worldwide	13
	Management Quality		23
	Operation and Outreach		22
	Portfolio and Financial quality		30
	Social mission criteia		27
	Total Asset of MFI		7

10. Investor

Type	Name		Sources
	How to invest		2
	Inception date		3
	Interest Payment Date		6
	Length of investment		6
	Mini amount $		7
	Type of Investors		
	Type	Name	Sources
		Fund of fund	18
		Institutional Investor	46
		Private Donor	21
		Private individual	35
		Public investor	27

Type of return

Type	Name	Sources
	Dividend	1
	Interest	5

11. Fund Objective

Type	Name	Sources
	Double bottom line objective	26
	Economic Development	35
	Improve affordable financial services	30
	Improve MFIs for growth	19
	Others (broader portfolio, combination technical and financial partnership, active investor)	6
	Product and Geographic diversification	6
	Seek and forge partnership with investor and MFIs	7
	Triple bottom line objective	6
	Vehicle to flow capital to MFIs	29

12. Exit Strategies 5

2. Investment Sector (Eligible Partners)

By Charter

Type	Name	Sources
	Assoicate producer,Fair Trade	5
	Commercial Bank	4
	Credit Unions&Cooperatives	10
	Development Bank	11
	Microlending Companies	11
	NGOs	10
	Non Bank Financial Institution	9
	Other investment funds	8
	Small Medium Enterprises (SMEs)	12
	Social Venture,Housing Developer	6
	Technology Company	4

By Development stages of MFIs

Type	Name	Sources
	Large-sustainable MFIs (Mature stage)	15
	Mid-size, growth-oriented MFIs (Expansion stage)	31
	Small, start up MFIs (Emerging stage)	29

By Segmentation (Tier)

Type	Name	Sources
	Tier 2	4
	Tier 3	2
	Tier1	1

3. Investment structure

Type	Name	Name	References
	Collaterial		10
	Currency to invest in MFI		
	Type	Name	Sources
		Hard currency	33
		Local Currency	31
	Date of payment		9
	Fees		9
	Financial Instrument		0
	Type	Name	Sources
		Equity finance	47
		Guarantees	25
		Loans	62
		Other instrument	23
	Length of investment		28
	Limitation of investment in MFIs		32
	Return or Interest earn		9

4. Investment Process

Type	Name	Sources
	1. MFI Identification	17
	2. Market Source, Investment analysis	18
	3. Due diligence and review	15
	4. Investment Approval, Terms of Agreement	15
	5. Portfolio construction, investment optimization	3
	6. Reporting	13
	7. Ongoing monitoring	13

5. Return	46
6. Risks or Losses	40
8. Hedging	13
9. Leverage	10

Appendix C

Investment Strategies

Extracted from ***Microfinance Investment Vehicles Disclosure Guidelines, CGAP, 2010****, page 6-8*

Code	Information	Description/Definition
1.3.1	Mission/Objective	A brief description of the MIV's objective and investment strategy (Mission Statement).
1.3.2	Authorized Financial Instruments	Financial instruments that the MIV is authorized to use. Specify for each category the maximum amounts in percentage of total assets authorized in the prospectus (0 ! not authorized): - *Equity* - *Debt* - *Guarantee* - *Cash (minimum and maximum allowed)* - *Other*
1.3.3	Geographical Focus	The MIV's geographic mandate. Select the regions from the following categories and specify the maximum amounts in percentage of the portfolio or total assets authorized in the prospectus: - *Eastern Europe and Central Asia* - *Latin America and Caribbean* - *East Asia and Pacific* - *South Asia* - *Middle East and North Africa* - *Sub-Saharan Africa*
1.3.4	Eligible Partners/Target Microfinance Service Providers by Charter Type	The MIV's eligible partners/target microfinance service providers by charter type. Select the eligible partners from the following categories: - *Bank* - *Credit union/cooperative* - *NBFI* - *NGO* - *Consumer lending company* - *Technology company* - *Other MIV*

Code	Information	Description/Definition
1.3.5	Eligible Partners/Target Microfinance Service Providers by Tier	Specify the eligible partners/target microfinance service providers by tier as a percentage of the portfolio or total assets (if applicable): - *Top-tier microfinance service providers (over $30 million in assets)* - *Second-tier microfinance service providers (from $5 million to $30 million in assets)* - *Third-tier microfinance service providers (less than $5 million in assets)* *Note: There are different definitions of "tiers" based on various criteria (e.g., asset size, sustainability). For simplicity, we have included only asset size.*
1.3.6	Currency Limit	Maximum percentage of the portfolio or total assets that can be invested in currencies other than the fund's accounting currency.
1.3.7	Hedging Strategy	Select the MIVs hedging strategy from the following categories: - *Fully hedged* - *Fully unhedged* - *Partially hedged* (specify the minimum and maximum amounts of authorized unhedged positions as a percentage of the portfolio or total assets)
1.3.8	Leverage	Is the MIV allowed to borrow to leverage investor equity? If so, specify the maximum allowed leverage ratio.

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